

Report



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How an intrafamily loan can help you transfer wealth

Lending money to your loved ones can be a great way to help them out financially. It can also be a tax-smart strategy for transferring wealth to family members, particularly in today's low-interest-rate environment.

If your estate exceeds the lifetime gift and estate tax exemption (\$5 million in 2011 and 2012), intrafamily loans offer a tool for additional tax-free transfers. Even if your net worth is well under \$5 million, there may be good reasons to lend money rather than give it away.

Why lend rather than give?

Lending rather than giving provides a couple of attractive benefits. First, you may not be ready to part with your wealth — for example, because you're concerned about having enough money to fund your retirement or you feel that your children aren't ready to handle the responsibility. Intrafamily loans allow you to provide family members with financial support while hanging on to your "nest egg" and encouraging your children to be financially responsible.

Avoid the temptation to make no-interest loans to family members (or loans with interest below the AFR).



strategies for tax-free transfers to preserve your exemption for future gifts.

How does it work?

When you lend money to family members, it's important to charge interest at the applicable federal rate (AFR) or higher. Otherwise you'll trigger unintended income and gift tax consequences.

The key to transferring wealth is the borrower's ability to take advantage of investment opportunities that offer relatively high returns. In other words, after paying back the principal, the borrower essentially receives the "spread" between the investment returns and the loan interest — free of gift and estate taxes. (See "An intrafamily loan in action" on page 3.)

The good news is that AFRs have been very low, making it easier for a borrower's investments to outperform the interest rate on a loan. The AFRs, which are published monthly, vary depending on whether the loan is short-term (three years or less), mid-term (more than three years but not more than nine years) or long-term (more than nine years). They also vary depending on how frequently interest is compounded.

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Second, if you believe that Congress will retain the \$5 million exemption (which currently is scheduled to drop to \$1 million in 2013), you might want to use intrafamily loans or other

As of this writing, the average monthly AFRs for loans compounded annually are:

- ⊙ Short-term 0.376%,
- ⊙ Mid-term 2.0%, and
- ⊙ Long-term 3.86%.

Average AFRs are expected to remain low for the second half of the year. These low interest rates, particularly for short-term loans, make intrafamily loans an attractive option.

Keep in mind that the loan balance is still included in your taxable estate. Even if you die before the loan is paid off, the borrower must repay the loan to your estate, although an intrafamily loan can be structured to provide that the loan will be forgiven if you die before it's paid off.

What are the risks?

The biggest risk, of course, is that the invested funds will fail to outperform the AFR. If that happens, your child or other borrower will have to use his or her own funds to pay some or all of the interest — and, if he or she experiences a loss on the investment, even some of the principal. In other words, instead of transferring wealth to your child, your child will transfer wealth to *you*. As noted above, however, low AFRs minimize this risk.

There's also a risk that the IRS will challenge the loan as a disguised gift, potentially triggering gift tax liability or using up some of your lifetime exemption. To avoid this result, you must treat the transaction as a legitimate loan. That means documenting the loan with a promissory note and adhering to its payment and enforcement terms. So, for example, if your child is unable to make a payment, you should make a genuine effort to collect the funds from the child.

Avoid the temptation to make no-interest loans to family members (or loans with interest below the AFR). If you do, you'll be subject to income tax (with certain exceptions for smaller loans) on

An intrafamily loan in action

The following scenario helps explain how an intrafamily loan can help you leverage a loan to transfer wealth to a child free of gift and estate taxes.

Dave lends \$2 million to his daughter, Anna, for three years. Anna signs a promissory note, which requires annual payments of interest only at the AFR in effect at the time of the loan, or 0.5%. The note also calls for a balloon payment of principal at the end of the three-year term.

Anna places the borrowed funds in investments that earn a 5% return. At the end of the loan term, after using the investment income to make interest payments of \$10,000 per year and repaying the principal, she is left with roughly \$283,725. Dave has essentially transferred that amount to her gift- and estate-tax-free.



imputed interest — that is, the excess of the AFR over the interest you actually collect. So, you'll be taxed on interest that you didn't receive. In addition, the imputed interest will be treated as a taxable gift to the borrower.

The right strategy for you

The intrafamily loan is just one of many tools available for transferring wealth to your loved ones in a tax-efficient manner. Your tax and estate planning advisors can help you develop a strategy that reflects your particular financial situation and goals. ⊙

Act now

QSBS offers gain without the pain

Time is running out for a remarkable tax break for investors. If you invest in qualified small business stock (QSBS) by the end of 2011 and hold it for more than five years, you'll be able to sell the stock *tax-free*. That's right. Tax-free. Lawmakers have proposed making this tax break permanent, but unless they act before year end, you'll need to move quickly to take advantage of it.

A growing benefit

The QSBS provision of the tax code allows noncorporate taxpayers to exclude from gross income 50% (60% for certain investments) of any gains realized on the sale or exchange of QSBS issued after Aug. 10, 1993. The stock must have been held for more than five years.



Congress increased the exclusion to 75% for QSBS acquired after Feb. 17, 2009, and before Sept. 28, 2010, and to 100% for QSBS acquired after Sept. 27, 2010, and before Jan. 1, 2012.

Ordinarily, a portion of the gain from a sale of QSBS is a preference item, which is added back into income for alternative minimum tax (AMT) purposes. But for QSBS that qualifies for the 100% exclusion, the AMT preference doesn't apply.

Read the fine print

The QSBS rules are complex, so be sure you understand the requirements before you invest. To qualify as QSBS, the stock must be:

- ⊙ Issued after Aug. 10, 1993, by a C corporation with no more than \$50 million in gross assets before and immediately after issuance,
- ⊙ Issued by a company that uses at least 80% of its assets (by value) in one or more qualified trades or businesses — this *excludes* several types of businesses, such as professional and personal services, banking and other financial services, farming, restaurants, and hotels, and
- ⊙ Acquired on original issuance (directly or through an underwriter) by a noncorporate taxpayer, in exchange for money or property (other than stock) or as compensation for services.

If you're thinking about cashing in your stock and buying newly issued stock to take advantage of the 100% exclusion, think again. Section 1202 contains rules disqualifying stock if the company redeems stock from you or a related person within two years before the new stock is issued. And to prevent you from acquiring new stock first and then selling your old stock back to the

company, the provision also disqualifies stock from tax-free treatment if the company redeems any of your stock within two years *after* the new stock is issued.

There are detailed rules on many other issues, including calculation of a corporation's gross assets, evaluation of a corporation's compliance with the active business requirement and treatment of stock held by partnerships and other pass-through entities. Also, the amount of gain you can

exclude with respect to any one corporate issuer is generally limited to the greater of \$10 million or 10 times the adjusted basis of the QSBS.

Don't try this at home

The prospect of tax-free gains is enticing, but investing in QSBS involves many traps for the unwary. Given the complexity of the QSBS rules, make sure you consult your tax advisor before you invest to avoid unpleasant surprises on your tax bill. ☹

Want to defer tax?

Consider a Sec. 1031 exchange

If you're like many taxpayers, you want to defer tax when possible. Fortunately, the Internal Revenue Code (IRC) provides a great way to do just that: a Section 1031 (or like-kind) exchange, which is especially useful for deferring gains on business or investment real estate.

Tit for tat

Sec. 1031 allows you to defer the gain on real or personal property used in a business or held for investment if, instead of selling it, you exchange it solely for property of a "like kind." For personal property, that means property of the same asset or product class.

But virtually any type of real estate will qualify as long as it's business or investment property. You can exchange an office building for a warehouse, for example. But you can't exchange your personal residence unless you first convert it into an investment property.

It can be difficult to find someone with whom you can simply swap properties. So most Sec. 1031 transactions are deferred exchanges, in which you engage a qualified intermediary (QI).



When you sell your property (the relinquished property), the proceeds go directly to the QI, who uses the net proceeds to buy replacement property. To qualify for tax-deferred exchange treatment, you must identify replacement property within 45 days after you sell the relinquished property and complete the purchase within 180 days after the initial sale.

Go in reverse

Say you come across an ideal investment property that you'd like to trade into, but there's no

time to sell an existing property. In that case, a reverse exchange may be the answer.

In a reverse exchange, a special type of QI, called an exchange accommodation titleholder (EAT), acquires title to the replacement property before you sell the property you'd like to relinquish. You can defer capital gains by identifying one or more properties to exchange within 45 days after the EAT receives the replacement property and completing the transaction within 180 days. There's a narrow exception to the 180-day rule, but it's a more complex transaction.

Avoid the traps

A like-kind exchange offers many benefits, but there are five potential traps that you should be aware of:

- 1. You receive (or obtain control of) sale proceeds or you acquire title to replacement property before you sell the property you're exchanging.** In either situation, the transaction won't qualify for Sec. 1031 treatment and your gain will be taxable immediately. That's why using a QI or EAT is critical.
- 2. You exchange your property for a property of less value.** Generally, it's best to exchange real estate for property of equal or greater value. Any cash or other non-like-kind property — known as “boot” — that you receive is immediately taxable. One way to avoid negative tax consequences is to

have your intermediary use boot to make improvements to the replacement property or invest it in other like-kind properties.

- 3. You're a real estate dealer.** Those in the business of buying and selling real estate can't use a Sec. 1031 exchange to defer taxes on property held primarily for sale. Unfortunately, the line between a dealer and an investor isn't always clear. It depends on several factors, such as the number of properties you own and the frequency of sales.

Those in the business of buying and selling real estate can't use a Sec. 1031 exchange to defer taxes on property held primarily for sale.

- 4. You make the exchange for property that doesn't qualify.** Investors often make the mistake of exchanging real estate for an interest in a partnership that owns real estate or a real estate investment trust (REIT). But partnership interests and REITs don't qualify as like-kind property.

- 5. The exchanged property isn't similarly titled.** The exchanged property and the replacement property must be similarly titled or you'll lose the benefit of the deferral. For example, if you and your business partner jointly own a piece of land and you wish to exchange it for a parcel that you're going to buy with your spouse, you won't be able to defer the gain.

Know what you're getting into

Make sure you know the rules before entering into a Sec. 1031 exchange, because these transactions are fraught with potential traps. Also keep in mind that tax rates are scheduled to increase in 2013. If Congress doesn't extend the lower rates, an exchange could ultimately increase your tax liability. Work with your tax advisor to determine whether an exchange is right for you. ☺



tax TIPS

Good news for gift card sellers

Advance payments for goods or services to be provided in the future are usually included in income when they're received. But there are some exceptions for sales of gift cards.

You can defer gift-card income for one year to the extent you defer the revenue on a qualifying financial statement. A two-year deferral is available for the unredeemed portion of a gift card that's redeemable for merchandise (as opposed to services).

The IRS has issued two rulings regarding gift-card income. They allow qualifying taxpayers to defer gift-card income even if they 1) sell gift cards that may be redeemed for goods or services provided by third parties, or 2) issue gift cards in exchange for returned merchandise. ☺

Know the facts before you invest in municipal bonds

Municipal bonds issued by state or local governments can be a sound investment, particularly for high-income taxpayers. While these bonds are often touted as "tax-free," that description isn't always accurate.

For example, although they're exempt from federal income taxes, they may be subject to state income taxes. Most states exempt "home-state" bonds from income tax, but others apply their income tax to out-of-state bonds. Also, private activity bonds — government bonds used to finance private projects — may be subject to the alternative minimum tax (AMT).

Even if municipal bond interest is tax-free, you should calculate the taxable equivalent yield to determine whether it's a good deal. Suppose, for example, that you're comparing a tax-free municipal bond that earns a 4% return with a taxable investment that earns 6%. If you're in the 35% tax bracket, the after-tax return on the latter is 3.9%, so you're slightly better off with

the municipal bond. But if you're in the 25% tax bracket, the after-tax return is 4.5%, which outperforms the municipal bond. ☺

Watch out for audit red flags

For most people, the chances of being audited by the IRS are slim. However, the IRS looks for certain red flags, such as:

1. Reporting income less than that reported on W-2s and 1099s,
2. Claiming a home office deduction,
3. Taking large charitable deductions,
4. Claiming the first-time homebuyer credit,
5. Claiming large deductions for business meals, travel and entertainment,
6. Reporting 100% business use of a vehicle, and
7. Claiming large "hobby" losses.

If any of these potential audit triggers apply to you, be certain they're legitimate and well documented. ☺



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Developments Affecting California Taxpayers

Internal Revenue Service (“IRS”) Hunt for California Gift Tax Evaders: In March 2011, the IRS filed a lawsuit in the U.S. District Court in Sacramento. It sought access to the California Board of Equalization database of everyone who transferred real estate for little or no consideration between 2005 and 2010. If granted, it could expose many Californians — especially those who didn’t file federal gift tax returns — to audits as well as penalties or back taxes. In May 2011, the Court denied the petition because the IRS did not meet its burden in showing that the information was not readily available from other sources. The information is available in each California County Clerk Recorder’s office.

Contributions to Section 501(c)(4) organizations: The IRS has recently suspended examinations relating to the possible gift tax consequences of contributions made by wealthy donors to 501(c)(4) organizations after facing significant public backlash. The IRS will determine if further guidance is needed in this area and no IRS examination resources will be expended on this issue until further notice.

Guidance on Employee Use of Cell Phones: In Notice 2011-72, the IRS addressed the tax treatment of employer-provided cell phones used by employees for noncompensatory business purposes. The notice states that business and personal use of an employer-provided cell phone is generally nontaxable to the employee. Further, the IRS will not require recordkeeping of business use in order to receive this tax-free treatment, according to the notice.

IRS Extends Filing Due Date for Carryover Basis Form to Early 2012: The IRS announced that large estates of people who died in 2010 will now have until early next year to file required returns and pay any estate taxes due, among them the Form 8939 for electing into the carryover basis regime. A longer lead time in filing the form is a much sought-after piece of relief from the new modified carryover basis plan. Under Notice 2011-76, large estates opting out of the estate tax regime now have until Jan. 17, 2012, to file Form 8939. The special carryover basis form, Allocation of Increase in Basis for Property Acquired From a Decedent, which is required of estates making that choice, was previously due Nov. 15, 2011.

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