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Exciting news here at CIA:

Art has recently been named to the American College Hall of Fame. He will become official at an induction ceremony in Las Vegas this November.

Mitchell has recently completed the testing for his Chartered Advisor in Philanthropy and will become official any day now.

For the second year in a row Art has been named a Five Star Wealth Manager.*

*The Five Star Award based on 10 objective criteria associated with providing quality services to clients such as credentials, experience, and assets under management among other factors. Wealth managers do not pay a fee to be considered or placed on the final list of 2013 Five Star Wealth Managers.

**October 2013**



# CIA Report

*Financial Intelligence*

## 2013 Year End Planning

This is the last quarterly newsletter we will be publishing this year. We thought we'd share some frequent year end comments from clients that might be useful to you for your year end planning.

**I'd like to take a charitable donation to reduce my income taxes, but don't know which charities I would like to support .**
You might consider a gift to a Donor Advised Fund. (DAF) In its simplest terms a DAF is a charity without a final beneficiary. The money you donate in 2013 is fully deductible for 2013 taxes as long as it doesn't exceed the maximum allowed by law. The advantage is that you can pick the charity or charities you wish to support when you get around to it. You can involve family members in picking the charities as a great way to teach philanthropy to another generation. We would be happy to direct you to such funds or other resources for further information.

**I'm self-employed and looking for a deduction.**
Regardless of whether you are a corporation, partnership, or sole-proprietor it may be possible for you to have a retirement plan designed for the kind of deduction you would like to have. It requires earned income – not passive investment income. Even if you have a plan, redesign might help you achieved a better result.

Another possibility is that you consider purchasing Long Term Care protection through your business. Under the law premiums can be deductible up to certain limits. The State of CA has prepared a booklet "Taking Care of Tomorrow". It is the exclusive property of the State of CA and the CA Department of Aging with all rights reserved. The California Department of Aging grants permission to members of the general public to download it for personal use. Let us know if you want a copy.

**I want to defer my tax deductions.**
Many of our clients are concerned about starting qualified retirement plans or continuing to fund them. Here is their concern: If taxes go up then the net result of having a current plan is that I will deduct my contributions in a low tax environment and pay taxes on all of my contributions and earnings in a higher tax bracket. The solution might be setting up a Roth IRA or a Roth 401(k). Contributions are not deductible but the income comes out tax free when you might be in a higher tax bracket.

If you have your own business you might want to consider a non-qualified deferred compensation plan. Although contributions are not deductible, the law allows for the plan to be discriminatory. Business owners are allowed to cover just themselves – no employees required. That savings alone could be greater than the deduction. Much like a Roth IRA, the income is not taxed when taken at retirement. If you think that shoe might fit you, it is best to look into it prior to year end.

**My tax bracket is different this year than it will be in future years.**
We talk to each of you at the end of the year about your investments. If your tax bracket is abnormally low, look at taking capital gains or converting to a Roth IRA. If your tax bracket is high, look for one time deductions that might cause taxable income later. There are tax credit programs out there for those who are looking to be a bit more aggressive with their investments.

**One last thought – but it's about your car.**
If you need to buy a new car, take into consideration going “green”.All electric cars are subject to some healthy state and federal tax credits.They may not last forever, so now is a good time to think about it.(Mitch and Art both drive electric cars.Our money is where our mouth is!)

# All in the Family: Transferring a Business to Your Children

***With a grantor retained annuity trust (GRAT), you receive a fixed dollar amount that does not change even if the value of the trust property (corpus) increases or decreases. Some other types of trusts are a grantor retained unitrust (GRUT) and a rolling or cascading GRAT. A GRUT allows you to retain the right to receive a fixed percentage of the trust corpus (determined annually), while a rolling or cascading GRAT is a technique that involves creating a series of short-term GRATs (typically two or three years) with each successive GRAT being funded by the annuity payments from the previous ones. This technique can minimize the risk of the grantor dying during the GRAT term, and can also minimize interest rate risk.***

You've spent years building a family business that's a source of pride and income for both you and your family, and now you may be thinking of handing over the reins to your children. If so, consider that transferring your business interest to your children may have income, gift, and estate tax consequences. Careful planning can help prevent the need to sell some (or all) of the business assets to pay those taxes.

Some common strategies for minimizing taxes are discussed briefly below. Remember, however, that none of these strategies are without drawbacks. Before you act, consult a tax professional as well as your estate planning attorney.

## Gifting or bequeathing your interest outright

If you don't need continued income from the business and you don't want to retain some control, you can simply give the business to your children outright. For example, you can begin a systematic program of making annual gifts to your children in amounts that equal the annual gift tax exclusion ($14,000 per year per recipient in 2013). By transferring your interest in this manner, you may be able to transfer all or a significant portion of the business free from federal gift tax (although these transfers may still be subject to state gift tax). The disadvantage here is the amount of time that may be needed to transfer your entire interest.

If you can wait and transfer your business at your death, Section 6166 of the Internal Revenue Code allows any estate taxes incurred because of the inclusion of your family business in your estate to be deferred for 5 years (with interest-only payments for the first 4 years), and then paid in annual installments of interest and principal over a period of up to 10 years. This will allow your beneficiaries more time to raise sufficient funds to pay the taxes or obtain more favorable interest rates if they need to borrow the money. Be aware that the business must exceed 35% of your gross estate and other requirements must be met.

## Selling your interest outright

If you need income from your business, you can sell your business interest (for full fair market value) to your children. This will avoid gift and estate taxes, but you may owe capital gains tax.

## Using a buy-sell agreement

If you want to sell your business interest to your children but retain control over the business for a period of time, consider using a buy-sell agreement. This is a legal contract that states that the sale will happen when a specific event occurs, such as your retirement, disability, divorce, or death. When the triggering event occurs, the children will be obligated to buy your interest from you or your estate. The price and sale terms will have been predetermined by the contract. Remember, however, that you will be bound under a buy-sell agreement: you won't be able to sell or give your business to anyone except the buyers named in the agreement (unless they consent).

## Using a grantor retained annuity trust (GRAT)

A GRAT is a trust into which you transfer your business interest, and from which you receive income for a period of time. The value of the gift is determined using the IRS's current interest rate (published monthly by the IRS). The trust must terminate at a specified time (e.g., 10 years). You receive annuity payments during the term of the trust, and at the end, your children will receive the business. If the business has appreciated beyond the IRS's interest rate, the excess can pass tax free. Be aware, however, that if you die during the GRAT term, your entire business interest will be included in your gross estate for federal estate tax purposes. You will have failed to transfer your business interest and lost the tax advantages of the GRAT. Plus, you will have incurred the costs of creating and maintaining the GRAT for nothing. For these reasons, be sure to structure your GRAT carefully.

## Creating a family limited partnership (FLP)

An FLP is a type of business entity. First, you establish a partnership with both general and limited partnership interests. Then, you transfer the business to this partnership. You retain the general partnership interest for yourself, allowing you to maintain control over the day-to-day operation of the business. Over time, you gift the limited partnership interests to your children, leveraging your lifetime gift tax exemption and the annual gift tax exclusion. You also save taxes because the value of the gifts may be eligible for valuation discounts, such as the minority interest and lack of marketability discounts.

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# Estate Planning and Income Tax Basis

***Income tax basis can be important when deciding whether to make gifts now or transfer property at your death. When you make a gift of property, the recipient generally receives your basis in the property. When you transfer property at your death, the recipient generally receives a basis equal to the fair market value of the property. The difference can substantially affect the amount of taxable gain when the recipient sells the property.***

Income tax basis can be important when deciding whether to make gifts now or transfer property at your death. This is because the income tax basis of the person receiving the property depends on whether the transfer is by gift or at death. This, in turn, affects the amount of taxable gain subject to income tax when the person sells the property.

## What is income tax basis?

Income tax basis is the base figure you use when determining whether you have recognized capital gain or loss on the sale of property for income tax purposes. (Gain or loss on the sale of property equals the difference between your adjusted tax basis and the amount you realize upon the sale of the property.) When you purchase property, your basis is generally equal to the purchase price. However, there may be some adjustments made to basis.

## What is the income tax basis for property you receive by gift?

When you receive a gift, you generally take the donor's basis in the property. (This is often referred to as a "carryover" or "transferred" basis.) The carried-over basis is increased--but not above fair market value (FMV)--by any gift tax paid that is attributable to appreciation in value of the gift (appreciation is equal to the excess of FMV over the donor's basis in the gift immediately before the gift). However, for purpose of determining loss on a subsequent sale, the carried-over basis cannot exceed the FMV of the property at the time of the gift.

***Example:*** *Say your father gives you stock worth $1,000. He purchased the stock for $500. Assume the gift incurs no gift tax. Your basis in the stock, for the purpose of determining gain on the sale of the stock, is $500. If you sold the stock for $1,000, you would have gain of $500 ($1,000 received minus $500 basis).*

*Now assume that the stock is only worth $200 at the time of the gift and you sell it for $200. Your basis in the stock, for purpose of determining gain on the sale of the stock, is still $500; but your basis for purpose of determining loss is $200. You do not pay tax on the sale of the stock. You do not recognize a loss either. In this case, your father should have sold the stock (and recognized the loss of $300--his basis of $500 minus $200 received) and then transferred the sales proceeds to you as a gift. (You are not permitted to transfer losses.)*

## What is the income tax basis for property you inherit?

When you inherit property, you generally receive an initial basis in property equal to the property's FMV. The FMV is established on the date of death or on an alternate valuation date six months after death. This is often referred to as a "stepped-up basis," since basis is typically stepped up to FMV. However, basis can also be "stepped down" to FMV.

***Example:*** *Say your mother leaves you stock worth $1,000 at her death. She purchased the stock for $500. Your basis in the stock is a stepped-up basis of $1,000. If you sold the stock for $1,000, you would have no gain ($1,000 received minus $1,000 basis).*

*Now assume that the stock is only worth $200 at the time of your mother's death. Your basis in the stock is a stepped-down basis of $200. If you sold the stock for more than $200, you would have gain.*

## Make gift now or transfer at death?

As the following example shows, income tax basis can be important when deciding whether to make gifts now or transfer property at your death.

***Example:*** *You purchased land for $25,000. It is now worth $250,000. You give the property to your child (assume the gift incurs no gift tax), who then has a tax basis of $25,000. If your child sells the land for $250,000, your child would have taxable gain of $225,000 ($250,000 sales proceeds minus $25,000 basis).*

*If, instead, you kept the land and transferred it to your child at your death when the land is worth $250,000, your child would have a tax basis of $250,000. If your child sells the land for $250,000, your child would have no taxable gain ($250,000 sales proceeds minus $250,000 basis).*

In addition to income tax basis, you might consider the following questions:

- Will making gifts reduce your combined gift and estate taxes? For example, future appreciation on gifted property is removed from your gross estate for federal estate tax purposes.
- Does the recipient need a gift now or can it wait? How long would a recipient have to wait until your death?
- What are the marginal income tax rates of you and the recipient?
- Do you have other property or cash that you could give?
- Can you afford to make a gift now?

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This information is not intended to be a substitute for specific individualized tax advice. We suggest that you discuss your specific tax issues with a qualified tax advisor.

## What return are you really earning on your money?

If you're like most people, you probably want to know what return you might expect before you invest. But to translate a given rate of return into actual income or growth potential, you'll need to understand the difference between nominal return and real return, and how that difference can affect your ability to achieve financial goals.

Let's say you have a certificate of deposit (CD) that's about to expire. The yield on the new five-year CD you're considering is 1.5%. It's not great, you think, but it's better than the 0.85% offered by a five-year Treasury note.*

But that 1.5% is the CD's nominal rate of return; it doesn't account for inflation or taxes. If you're taxed at the 28% federal income tax rate, roughly 0.42% of that 1.5% will be gobbled up by federal taxes on the interest. Okay, you say, that still leaves an interest rate of 1.08%; at least you're earning something.

However, you've also got to consider the purchasing power of the interest that the CD pays. Even though inflation is relatively low today, it can still affect your purchasing power, especially over time. Consumer prices have gone up by roughly 1% over the past year.**

Adjust your 1.08% after-tax return for inflation, and suddenly you're barely breaking even on your investment.

What's left after the impact of inflation and taxes is called your real return, because that's what you're really earning in actual purchasing power. If the nominal return on an investment is low enough, the real return can actually be negative, depending on your tax bracket and the inflation rate over time. Though this hypothetical example doesn't represent the performance of any actual investment, it illustrates the importance of understanding what you're really earning.

In some cases, the security an investment offers may be important enough that you're essentially willing to pay someone to keep your money safe. For example, Treasury yields have sometimes been negative when people worried more about protecting their principal than about their real return. However, you should understand the cost of such a decision.

*Source: Department of the Treasury Resource Center (www.treasury.gov) as of April 2013.

**Source: Bureau of Labor Statistics, Consumer Price Index as of April 2013.