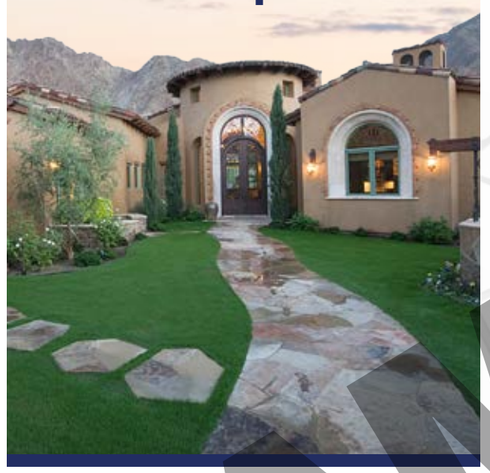
Sidestepping potential tax traps when transferring property to related parties



Suppose you own property you intend to transfer to your loved ones. Perhaps you are considering giving your children an ownership interest in your principal residence. But before you act, review the tax consequences of your decision as tax laws include provisions involving sales to related parties.

As you might imagine, the IRS's definition of a related party covers relatives like your children, grandchildren and siblings, but also applies to business entities you own. Here are several common situations you may encounter, and tips to help you avoid a tax surprise:

■ **Installment sales.** With an installment sale of investment or business real estate over two or more years, you can defer tax on your gain until the tax years in which payments are actually received. However, if you sell the property to a related party who disposes of it within two years, the remaining tax is due immediately.

Tip: *To solve this problem, insert language in the sale or transfer agreement that does not allow the disposition of the property within two years.*

■ **Selling at a discount.** If you're selling a house to a related party, you may wish to give that person a sweetheart deal. Unfortunately, the IRS may step in and reclassify the transaction as a gift if the property is sold at considerably less than its fair market value.

Tip: *Err on the side of safety by having an appraisal of the property before the transfer date OR build documentation that justifies the fair market value.*

■ **Transferring remainder interests.** In some cases, you may wish to transfer an ownership interest in your home or your estate while continuing to live there. Although this may meet your estate planning objectives, the estate can't take advantage of the $250,000 home sale exclusion ($500,000 for joint filers). However, if your heirs subsequently meet the two-out-of-five-year ownership and use requirements, the exclusion becomes available once again.

Tip: *Prior to transferring interest in your home to anyone (including a trust or an estate), understand the impact of this action on the tax-free home gain exclusion.*

■ **Like-kind exchanges.** Taxable gains can be deferred when selling qualified real estate property. The tax is generally deferred until the replacement property is sold, but the tax law imposes a two-year holding requirement on the parties to a deal. Alternatively, you may qualify under a special exception, such as proving tax avoidance wasn't the purpose of the sale.

Tip: *Related property transactions of this type can get complicated. Ask for a review of your situation before trading any property and speak with an expert who handles these types of transactions.*

As you can see, transferring property to family members can get complicated and cause undue tax obligations if not handled correctly. So seek advice long before transferring key assets. ❑

TAX PLANNING INSIGHTS

MidYear 2022

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Dear Clients and Friends,

With tax season behind us, now is the perfect time to begin looking at planning strategies to cut your tax bill on your 2022 return. Each tax year looks different than the one before, and this year is no different. To help kick start your planning this year, included in this issue are four surefire ideas to help get you started.

But tax planning isn't just about your tax return. So included here are ideas for small businesses, some tax strategies for your trust, and things to think about when transferring property.

These insights are sent as a reminder of our commitment to help you minimize your taxes. Please call if you have any questions about tax planning for your 2022 return.

tax planning tips for 2022

Now is a great time to start tax planning for your 2022 tax return. Here are some ideas to consider.

Check your withholding

Confirm you have the right amount withheld from your paycheck for the balance of the year. It's especially important to review if you recently had a change in income, or you've experienced a big life event, like a new child or a home purchase. This exercise will help you to avoid paying underpayment penalties or inadvertently providing an interest-free loan of your money to the IRS.

You can check your withholding using the IRS Withholding Tool. Visit https://www.irs.gov/individuals/tax-withholding-estimator and click "Use the Tax Withholding Estimator." If you need to change your withholding, complete a new Form W-4 and submit it to your employer as soon as you can.

Forecast your income and profit

It is a good idea to forecast your taxable income for 2022 and compare it to last year. This is especially important if you own a business or receive income from investments. You can also use your forecast to budget how much you'll need to save each month so you won't have a huge tax balance to scramble to pay at the end of the year.

Prioritize retirement and savings plans

Take time to review your 401(k), individual retirement account (IRA), health savings account (HSA) and other savings accounts to ensure you're maximizing your tax savings. Establish a regular contribution schedule early in the year, while taking into account new maximum contribution limits. And if you're working, take full advantage of your employer's retirement contribution matching program.

Conduct an investment strategy review

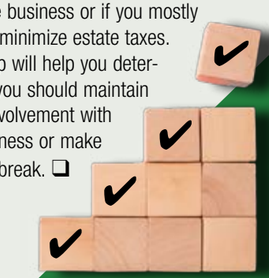
If you have not already done so, now is the time to conduct a review of your investment portfolio. This will help you create a tax-efficient strategy that allows you to allocate assets to accounts where tax savings can be maximized. For example, you may want to re-balance your investments to align to your retirement plan risk goals.

Finally, part of minimizing your tax bite this year should also include sitting down to conduct a robust tax planning session. Tax laws continually change and you can almost always adjust to take full advantage of these changes. So call if you would like assistance! ❑

SUCCESSION PLAN TIPS FOR YOUR BUSINESS

Consider these ideas as you create a succession plan for your business:

- **Determine your options.** Often, business owners want to pass the business on to their children or other family members. If you're considering this, have a frank discussion with your family to find out who wants to take on the business, as well as if they are willing to and have the capacity to do so.
- **Make your business appealing to buyers.** Provide a plan to boost your sales and cash flow by liquidating overstock inventory or retiring burdensome debt if your business isn't doing as well as planned.
- **Create a valuable team.** Financial experts can help review and create succinct, understandable financial statements, while a trusted lawyer can work with you on necessary legal documents and help you negotiate terms of a potential sale or ownership transfer.
- **Construct a solid buy/sell agreement.** Sometimes an owner wishes to quit, becomes disabled or passes away. Your succession plan needs to account for unplanned events. The best way to be prepared is to create and maintain a buy/sell agreement which spells out how assets and other business interests will be distributed should an owner wish to exit the business.
- **Think through your transition.** Take some time to think about issues, like whether you need retirement income from the business or if you mostly want to minimize estate taxes. This step will help you determine if you should maintain some involvement with the business or make a clean break. ❑



Tax strategies for trusts

There are many legal reasons why you would want to create a trust, including to avoid the probate process and setting rules for how you want certain assets and/or money to be used.

But when creating a trust, you also need to consider how the money and assets inside the trust will be taxed. Here are some suggestions for effectively dealing with the tax liability created by a trust.

▶ Distribute trust income to beneficiaries

To hit the top tax rate of 37% in 2022, a taxpayer who is single would need to have taxable income of $539,900 ($647,850 married). By comparison, income from certain types of trusts would begin getting taxed at 37% at only $13,450. That's a pretty big incentive to distribute income generated by certain trusts. So if a trust's beneficiary is in a lower tax bracket, a distribution to the beneficiary could result in a smaller tax liability.

▶ Use your annual gift exclusion

You can give any person or trust up to that year's gift exclusion amount ($16,000 for 2022) with neither you nor the recipient needing to report it. But the annual exclusion is a "use it or lose it." If you don't use the exclusion for one tax year, it can't be carried forward to another tax year. There's also an unlimited gift exclusion for most medical and educational expenses that are paid directly to the provider. So create a gift giving strategy.

▶ Set up an intentionally defective grantor trust (IDGT)

As previously stated, a regular trust hits the top 37% tax rate at $13,450. An IDGT, however, doesn't hit the 37% rate until $539,900 if you're single, and $647,850 if you're married. The main trade-off when using an IDGT compared to other types of trusts is that an IDGT is irrevocable – once you place an asset inside an IDGT, you normally can't revoke the asset transfer in the future. So you'll potentially be able to significantly lower your tax liability with an IDGT, but in return you give up all control of the assets inside the IDGT.

Trusts can be a great tax savings tool, but they can be complex. It is always best to speak with experts in the field. Just ensure that both legal and tax experts are consulted. ❑