

LEAVING THE CABIN TO YOUR KIDS...THE TAX FAVORED WAY!

Most folks who own a cabin, a lake place, or a condo in Arizona intend to have those homes or ones like them for the rest of their lives. These “recreational”, or “lifestyle investments” have appreciated tremendously through the years. This looks good on your balance sheet, but from a tax perspective, it can be a bad thing, especially if your goal is to enjoy the benefit of these assets for your lifetime. First, the property taxes increase which makes the investment more expensive to hold. Secondly, the value increases in the estate, causing many people to pay a transfer tax upon their deaths at the state and or federal level.

The tax code provides solutions to the problem of asset values increasing in the estate, those who seek to use those remedies can have fantastic results.

We can transfer the property into a special trust designed to help people transfer their personal residences. It is a trust with split ownership interests. The person setting up the trust generally owns a retained interest in the trust. They will enjoy all of the rights and responsibilities of ownership for a period of time. At the end of that period of time the remainder interest is owned by the trust for the benefit of someone other than the person setting up the trust, usually the kids.

The split ownership interest also has an asset protection component. The trustee cannot act against the rights of the other beneficiaries, so if the person setting up the trust or the beneficiaries are being sued, these arrangements create a degree of creditor protection (a person cannot set these up if they suspect they may be subject to litigation, the protection is a side effect of a properly created trust). You don't give up control or use of the property because, the trustee of the trust (usually the person setting up the trust) rents the cabin back to the parents (themselves) for a reasonable rent that could be yearly, in an effort to transfer more assets to children in the form of rent, or seasonal in some amount approximating the taxes and upkeep of the property. The children would receive the property under the provisions of the trust after the parents pass away.

Why would you go through all of this? It is a painless way to reduce your estate taxes. Both the retained ownership interest and the remainder interest have a value. It's the IRS tables pegging of the value that makes this an effective tool.

When you set up a trust like this you are making a gift of the remainder interest to your children and that gift is taxable. The IRS has tables that help us determine the value of the gift. To create an easy example, if a sixty-five year old set up a trust for ten years in today's interest environment, and transferred a \$200,000 cabin to it, the IRS would perceive the present value of the gift made to the beneficiaries ten years in the future to be around \$110,000. Unless you have already used your one million dollar exemption, you will not have to pay a tax on the gift. If the cabin becomes worth \$500,000 before the present owner dies, their estate will avoid approximately \$175,000 worth of estate taxes. It is a repeal proof plan if you plan to have the property or one like it for the balance of your life, why not pass it on with much less tax? If the government repeals the tax, you break even, if they keep it, or reinstate it, you win: repeal proof.

The only real negative to this arrangement is the loss of stepped-up basis. Under current law (although the proposed repeal dramatically curtails the effectiveness of this tax benefit), certain assets, real estate being one of them, enjoy a basis step-up in the hands of the beneficiaries. If you bought a property for \$100,000 and it grew to be worth \$500,000, your heirs could sell the asset and pay no tax on the gain. In the state of Minnesota this would save your heirs roughly \$80,000 in income taxes. The federal and estate taxes savings in using this plan could be as high as \$250,000.

People should consider this technique if they have or will have a taxable estate or if they desire creditor protection of one kind or another, or both.

It can also be an effective way for a business owner to work on tax effective equalization of the estate to include children in and out of the business. These trusts should be set up to work in concert with other strategies in maximizing the value of your assets from a lifestyle as well as business, financial, and tax perspective and should generally serve to reduce your ultimate legal fees and insurance premiums.

None of this planning should be done in a vacuum. High Net Worth individuals and business owners need to seek out advisors who understand the myriad of choices offered by the tax code and the vision to recognize where to apply them. It may be that there are tools more suited to you than this one, even if this seems perfect to you today. There is a trust that looks very similar to this one involving income producing property that can be even more effective in *the right circumstances, so it is vital you consult an advisor* who **excels** in income, estate, and business succession planning.