

# THE BERNSTEIN REPORT

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Dear Reader,

The fall Congressional calendar may provide some extraordinary action on tax laws. Most of us are aware of the possibility of the expiration of the tax cuts provided during the Bush Administration. Many stimulus provisions from the Obama Administration are also slated to expire. The numerous temporary provisions have sunset dates between the end of 2010 and 2014. Notable provisions to expire at the end of this year are:

1. Relief from the so-called marriage penalty
2. The reduction of the capital gains rate to 15 percent for most taxpayers
3. The taxation of qualified dividends at the capital gains rate
4. The reduction in the 28, 31, 36, and 39.6 percent income-tax brackets to 25, 28, 33, and 35 percent respectively
5. The elimination of the phase-out of personal exemption for high income earners
6. The elimination of the limitation on itemized deductions
7. The larger (\$125,000) expensing limits under IRC Sec. 179
8. The 2010 gift-tax bracket of 35 percent (would be as much as 55 percent after the sunset)
9. The 2010 modified carryover basis rules for inherited assets
10. The 2010 repeal of the estate and generation-skipping transfer taxes

The possible expiration of these provisions will certainly create anxiety for taxpayers and legislators as the end of the year approaches. Certainly, the upcoming elections and the limited amount of active legislative days in the remainder of the year will add to the tension. We may be facing another eleventh-hour tax bill in December similar to the Health Care passage last year.

Cordially,

*Richard S. Bernstein*

**A Second Opinion Costs You NOTHING,  
But Could Save You MILLIONS!**

**WHEN IT COMES TO YOUR HEALTH, YOU GET A SECOND OPINION,  
SHOULD YOUR FINANCIAL WEALTH BE ANY DIFFERENT?**

## **A CLEVER TIP FOR HARVESTING CAPITAL LOSSES**

### **TAXATION OF CAPITAL LOSSES**

As we are all too aware, our turbulent economy has created significant capital losses for many of us. In fact, it is often suggested that we use the opportunity to harvest capital losses. Unfortunately, IRC Sec. 1211 limits taxpayers to a capital loss deduction to the extent of their capital gains and \$3,000 (\$1,500 if married and filing separately). However, as a result of incurring their capital losses, many individual taxpayers may never be able to utilize the losses if they are simply limited to deducting \$3,000 of capital losses a year to offset their other income.

### **PART-SALE PART-GIFT ALTERNATIVE**

An easy solution is to simply wait and ride out the storm, hoping for market and economic rebounds. In this month's letter, however, we will look at an interesting planning application of an old strategy; utilizing a part-gift, part-sale transaction to absorb the accumulated losses. While not specifically addressed in the Internal Revenue Code, Treasury Regulation Sec. 1.1001-1(e) instructs the transferor to realize a gain to "the extent that the amount realized exceeds the adjusted basis." However, a loss is not recognized in a part-gift, part-sale transaction.

The recipient's basis in a part-gift, part-sale transaction, under Treasury Regulation Sec. 1.1015-4, will be the greater of the amount paid for the property or the adjusted basis of the transferor (an increase in basis may occur if gift taxes are paid on the appreciated property pursuant to IRC Sec. 1015(d)). Further, the regulations also provide that "[f]or determining loss, the unadjusted basis of the property in the hands of the transferee shall not be greater than the fair market value of the property at the time of the transfer."

### **WHAT CAN THE PART-SALE PART-GIFT STRATEGY ACCOMPLISH?**

In harvesting capital losses, we can address the following planning objectives with a part-gift, part-sale transaction:

- The transfer of property to a lower generation family member
- Increased liquidity for the transferor
- Recognize a capital gain to take the tax benefit from accumulated capital losses
- Help the recipient have a higher income tax basis

### **AN EXAMPLE OF HOW IT ALL WORKS**

Dan, age 70, has owned land in a resort area for many years. Although Dan has not built a home on the property, he has maintained the land as an investment. Dan acquired the land for \$400,000 and it is currently worth \$800,000. Dan originally intended to hold onto the land with

the expectation that his daughter, Donna, would receive the land upon his passing. Donna has always dreamed of owning the land and building a house on it.

Like many of us, Dan's savings dropped significantly in value when the economy tumbled. Specifically, Dan lost over 40 percent in value in his portfolio and now feels the need to dispose of the land. During this time, Dan feared the possibility of further market decline and sold his entire stock portfolio to invest in bonds, thereby recognizing \$200,000 of capital losses.

In order to recoup some of these losses and increase his liquidity, Dan decides he must sell the land now. Luckily, Donna is a successful doctor and has the funds available (or can obtain financing) to purchase the land from her father. After reviewing his financial situation, Dan realizes that he only needs to recover \$400,000 on the sale of the land to assist him in regaining the requisite liquidity to maintain financial stability. Donna agrees to purchase the land from her father for \$400,000. What is the optimal way to structure this transaction between Dan and Donna?

One possibility would be to have Dan sell Donna one-half of his interest in the land at fair market value sale. Independently, he could gift the other half of the land to her. If the transaction is structured this way, both Dan and Donna will satisfy the overall planning objectives. Dan receives \$400,000 and Donna receives the entire property.

As previously indicated, one-half of the fair market value of the land is \$400,000 (the land is worth a total of \$800,000). The basis for that one-half of the land is \$200,000 (total basis for the entire land is \$400,000). Dan will therefore realize a \$200,000 capital gain under IRC Sec. 1001(a) on the sale of one-half of the land. Gifting the other half of the land will result in neither a gain or loss for income-tax purposes for Dan or Donna. If Dan has not made other significant taxable gifts, his \$1 million lifetime gift tax exclusion will easily eliminate any current gift-tax consequences and this transaction will ultimately reduce his potential estate tax liability.

This transaction provides Dan with some needed liquidity. It also allows him to take the tax advantages of his capital losses. Instead of paying additional federal taxes, Dan will simply use the \$200,000 capital gain recognized on the sale of the half interest of land to offset \$200,000 of his accumulated capital losses. Dan's ability to have \$200,000 of the accumulated capital losses absorbed currently is important since it is possible that he would otherwise be unable to use the losses for tax purposes during his lifetime.

For Donna, this is a win-win situation. Donna only pays \$400,000 for her father's land. However, Donna will now have a higher basis in the land, \$600,000 as a result of the part-gift, part-sale transaction than had the property been gifted outright (a gift of the land would result in a carryover basis of \$400,000 plus any applicable gift tax adjustment). Donna's basis of \$600,000 represents the combination of the purchased half of the land, \$400,000, plus, her Dad's adjusted basis in the other half of the land, \$200,000.

## Recent Cases and Ruling

### IRS WAIVES 60-DAY IRA ROLLOVER REQUIREMENT DUE ERROR BY FINANCIAL INSTITUTION

The taxpayer received a distribution from an IRA with the intent of accomplishing a rollover of the IRA to a new financial institution. He gave directions to the new financial institution to create an IRA account and place the funds in a specific investment. The taxpayer was assured that the rollover would qualify as tax free. He completed the documents to transfer the funds to the second institution, but the funds were mistakenly placed in a non-retirement taxable account. The taxpayer received a 1099-R and realized the funds had been handled inappropriately. The new institution verified the error and provided documentation of the inappropriate account. The IRS ruled (Ltr 201029020) that the 60-day rollover requirement for a tax-free transfer from one IRA to another would be waived and the distribution and rollover would qualify as tax free. There are numerous rulings concerning request for waivers of untimely or mishandled rollovers. Not all of them are dealt with favorably by the IRS. It is important to carefully check the titling of accounts and the investment choices when dealing with any transactions of this type.

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This Tax Letter is intended to assist you to conserve your estate and to protect the interests of your family and business associates. Estate planning involves the joint services of a competent Trust Officer, Attorney, Accountant, and Life Underwriter. The experience and advice of each is generally essential.

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