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White Paper

Estate Freeze Technique:

Bargain Sale

www.selectportfolio.com • Toll Free 800.445.9822 • Tel 949.975.7900 • Fax 949.900.8181

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Estate Freeze Technique: *Bargain Sale*

What is it?

A bargain sale is either of two types of transactions. One, you sell appreciated property to a charitable entity at a sale price below its fair market value (FMV). Two, you sell property to a family member or private buyer for a price that is less than its FMV.

With a sale to a charitable entity, you sell an asset to a charity for a price that is less than its FMV. In most cases, the charity will sell the asset for its full value (and pay no taxes on the gain). Generally, you can take a charitable income tax deduction for the difference between the FMV of the property and the price for which you sold it. In some cases, however, your charitable contribution will be limited to your cost of the property. You may have to pay income tax on your allocated part of the gain.

On the other hand, if you sell property to a family member or private buyer for less than its FMV, the difference between the sale price and the FMV is treated as a taxable gift. If the difference is in excess of the \$12,000 annual gift tax exclusion, you may owe federal gift tax. However, gift tax may be offset by your \$1 million gift tax applicable exclusion amount (formerly known as the unified credit), if it is available. Your state may also impose a gift tax.

When can it be used?

Few requirements to a bargain sale

There are very few requirements to structuring a bargain sale and no restrictions on the type of property that can be sold. There are no time restrictions on when the transaction can take place. However, if the bargain sale is to a charity, it must be a qualified charity to be tax-deductible. In addition, the normal limits on charitable contributions will apply.

For certain types of property, an appraiser should be hired

If you are selling property that is not easy to value, then you should hire an independent, qualified appraiser.

Example(s): You own artwork that you bought for \$10,000. You believe that its fair market value is \$25,000. You sell it to the local art museum for your cost--\$10,000. Before you take the charitable deduction of \$15,000, you should obtain a written appraisal of the fair market value of the artwork from a qualified, independent appraiser.

Strengths

Bargain sale is an excellent way to recover cost of asset and still make a charitable contribution

A bargain sale to a charity is an excellent strategy to recover your cost in an asset and still make a tax-deductible contribution.

Example(s): You own listed securities for which you paid \$20,000. The securities are now worth \$50,000. You want to donate the securities to your alma mater (a qualified charity), but also recover your cost. You can sell the securities to the institution for \$20,000 and still have a tax-deductible contribution of \$30,000. The \$50,000 of securities will then be removed from your gross estate for estate tax purposes.

Bargain sale to a family member is an effective strategy to remove assets from an estate

A bargain sale to a family member is an effective way to transfer assets to family members. The donor can remove the full value of the asset from his or her gross estate and still receive some compensation for the transfer. The compensation you receive, however, would become part of your gross estate.

Example(s): You own a piece of land with a basis of \$200,000 and a fair market value of \$500,000. Your son would like to own the land, but cannot afford to pay the \$500,000. You would like to remove the value of this asset from your estate. One solution is to sell the land to your son for \$200,000 (your cost).

Caution: The \$300,000 difference is considered a gift, and, if you have fully used the gift tax applicable exclusion amount, you may have to pay gift taxes on this amount.

Tradeoffs

Donor may owe taxes even on bargain sale to charity

On a bargain sale to a qualified charity, the donor may still owe income tax on his or her pro rata share of the appreciation of the asset. Under current law, you have to allocate your basis in the property between the part sold and the part donated. Therefore, even though the sale price to the charity may be the same as your original cost, you have to recognize a gain to the extent the sale price exceeds your adjusted basis with respect to the position that you sold.

Example(s): You own artwork that has a fair market value (FMV) of \$100,000. Your basis in the artwork is \$40,000. You sell the artwork to the local museum (a qualified charity) for \$40,000. The gift amounts to 60 percent of the value of the property. Sixty percent of your basis is

allocated to the gift (or \$24,000, in this case). The remaining 40 percent (\$16,000) of basis is allocated to the sale portion. You therefore have a taxable gain of \$24,000 (\$40,000 - \$16,000).

With a bargain sale to private buyer, you may owe gift taxes on the transaction

When you sell an asset to a private buyer for less than its FMV, the difference is a taxable gift. If you have fully used up the gift tax applicable exclusion amount, then you will owe gift taxes on that difference.

Example(s): You own property with an FMV of \$200,000. You sell that property to your son for \$100,000. The \$100,000 difference is a taxable gift to your son. You have previously fully used the applicable exclusion amount for other gifts. You will have to pay gift taxes on the \$100,000 gift less the \$12,000 annual gift tax exclusion.

How to do it

Pick a qualified charity

If you plan to sell an asset at a bargain price to a charity, the first step is to pick the charity. You should make sure that the charity is qualified so that your gift will be tax-deductible.

Hire an appraiser to appraise the value of the property

If the property you plan to sell at a bargain price is not easily valued (for example, artwork or real estate), you should hire a qualified, independent appraiser to appraise the fair market value of the asset. The amount of your charitable gift will be the difference between the amount of the sale and the fair market value of the property.

Accountant may be needed to calculate tax liability

In a bargain sale to a charity, the tax liability of the seller/donor may be fairly complicated to calculate. Unless you are very comfortable with complicated tax calculations, you may have to hire an accountant or tax attorney to help you with the tax calculations.

Tax considerations

Income Tax

In a bargain sale to a charity, seller/donor may incur tax liability

Under current law, you may have to recognize a taxable gain on a bargain sale to a qualified charity. You have to allocate your cost basis to the part sold and to the part donated. You then have to pay taxes on your pro rata share of the appreciation of the asset.

Example(s): You own listed securities currently worth \$500,000. Your basis is \$100,000. You sell those securities to the local hospital (a qualified charity) for \$100,000. The gift is 80 percent of the property. Eighty percent of the \$100,000 basis is then allocated to the gift portion, while 20 percent of the basis (or \$20,000) is allocated to the sale. Thus, you would have a taxable gain of \$80,000 (\$100,000 sale price minus the \$20,000 basis). The \$400,000 difference between the sale price and the fair market value (FMV) is a charitable contribution and would generally be tax deductible.

There are certain limitations on charitable deductions that you may take in any given year. Furthermore, some assets may be valued at their cost, rather than their FMV, for purposes of valuing the charitable deduction.

Gift and Estate Tax

Gift taxes may have to be paid on bargain sale to a private buyer

With a bargain sale, the difference between the FMV of the property sold and the actual sale price is a taxable gift from the seller to the buyer. Gift taxes may have to be paid on the difference.

Example(s): You sell your house worth \$400,000 to your daughter for \$200,000. The \$200,000 difference is a taxable gift from you to your daughter and gift taxes may be owed on this difference (less any other credit available, such as the annual gift tax exclusion). The taxable gift will reduce your gift tax applicable exclusion amount, and gift tax will be due currently if the exclusion is exhausted.

Bargain sale removes asset from gross estate

A bargain sale to either a private buyer or charitable entity removes that asset from your gross estate and replaces it with the consideration you receive in return. In the case of an asset that is sold below its FMV, gift taxes may be due at the time of the sale. A bargain sale is an excellent way to remove assets that will rapidly appreciate in the future from your estate.

Example(s): You own a piece of land with a basis of \$50,000 and an FMV of \$200,000. You believe that the land will continue to appreciate rapidly in the future. You have other substantial assets. You sell the land to your daughter for \$50,000. You will have to pay gift taxes on \$150,000 (\$200,000 - \$50,000) if you have fully used the gift tax applicable exclusion amount. The annual gift tax exclusion may also be available. However, any future appreciation in the value of the land will be removed from your estate.

Questions & Answers

What is the purpose of a bargain sale?

A bargain sale is an effective way to remove assets from your estate--especially those that are likely to appreciate rapidly in the future. One of the benefits of a bargain sale is that, unlike an outright gift, you receive some compensation for your transfer. For example, you may want to recover your cost in the asset.

What are the tax consequences of a bargain sale to a charitable entity?

The tax consequences of a bargain sale to a charitable entity are somewhat complicated because you must allocate your basis in the asset between the part donated and the part sold.

Example(s): You sell a painting with a fair market value of \$16,000 to your local museum (a qualified charity) for \$4,000 (your basis in the painting). You should allocate 75 percent of the basis in the painting to the gift portion and 25 percent to the sales portion of the transaction. Thus, your basis in the portion of the painting that you sold is \$1,000 ($\$4,000 \times .25$). You have received \$4,000. Therefore, you have a taxable gain of \$3,000 ($\$4,000 - \$1,000$). Of course, you will also have a tax-deductible charitable donation of \$12,000 ($\$16,000 - \$4,000$).

What are the alternatives to a bargain sale?

A popular alternative to a bargain sale is simply to donate or give the property to either the charity or another person. Of course, you will not receive anything back in a straight donation, other than possibly a tax deduction in the case of a gift to a charity. You may also owe a larger gift tax when you make a straight donation to another person.

Disclosures

This material does not constitute the rendering of investment, legal, tax or insurance advice or services. It is intended for informational use only and is not a substitute for investment, legal, tax, and insurance advice.

State, national and international laws vary, as do individual circumstances; so always consult a qualified investment advisor, attorney, CPA, or insurance agent on all investment, legal, tax, or insurance matters.

The effectiveness of any of the strategies described will depend on your individual situation and on a number of other factors. After reviewing your personal situation, we may recommend that you not use any strategy in this document but instead consider various other strategies available through our practice.

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