

tax IMPACT

March/April 2015

Transferring ownership
while retaining control
A GRAT or IDIT can help

529 plans: Fund college costs
the tax-advantaged way

Deferred compensation
Are you in compliance
with Sec. 409A?

Tax Tips
IRS transition rule for IRA rollovers,
government settlement payments, and more



Transferring ownership while retaining control

A GRAT or IDIT can help

If a large portion of your wealth is tied up in a family business, you may find that your estate planning goals conflict with succession-planning goals. If the value of your business is substantially greater than the gift and estate tax exemption (currently \$5.43 million), traditional estate planning techniques would have you transfer the business to your children or other family members as early as possible in order to remove future appreciation from your estate.

From a succession-planning perspective, however, handing over the reins to the younger generation may be premature. Perhaps the next generation of

leaders isn't yet ready to take over the business. Or maybe you're not ready to give up control.

Fortunately, there are several trust-based tools that allow you to transfer business interests to your successors *now* — minimizing gift and estate taxes — while maintaining control of the business. Two to consider are the grantor retained annuity trust (GRAT) and a sale to an intentionally defective irrevocable trust (IDIT).

In order for you and your family to enjoy the tax benefits of a GRAT, you must survive the trust term.

Take advantage of GRATs

With GRATs, you transfer business interests to an irrevocable trust, which pays you a fixed annuity for a set number of years. When the trust term ends, the assets are transferred to your children or other beneficiaries. You control the business during the trust term and continue to earn income in the form of annuity payments. For this technique to work, the business must generate sufficient income to fund the annuity payments.

In addition to removing future business appreciation from your taxable estate, a GRAT minimizes any gift tax liability on your initial transfer of interests to the trust. That's because the value for gift tax purposes is equal to the actuarial value of your beneficiaries' *future* interest in the trust. By adjusting the length of the trust term and the



size of the annuity payments, you can reduce the value to a very low amount — even to zero in some cases.

The main disadvantage of a GRAT is mortality risk. In order for you and your family to enjoy the tax benefits of this technique, you must survive the trust term. If you don't, trust assets will be pulled back into your taxable estate.

Harness the power of IDITs

Another powerful tool for obtaining tax benefits while retaining control of your business is a sale to an IDIT. Also known as an intentionally defective grantor trust (IDGT), a properly designed IDIT is an irrevocable trust for gift and estate tax purposes, but it's treated as a grantor trust for income tax purposes. (That's the "defect.") Because the trust is irrevocable, business interests you transfer to it are considered to be completed gifts, so any future appreciation in their value escapes estate taxes. At the same time, grantor trust status offers two important benefits:

1. As grantor, *you* pay income taxes on the trust's earnings, allowing trust assets to grow tax-free, leaving more for your beneficiaries (essentially, an additional tax-free gift).
2. For income tax purposes, a grantor trust is considered your alter ego rather than a separate entity, so any payments you receive from the trust are treated as tax-free payments to yourself.

Structuring the transaction as an installment sale rather than a gift offers additional benefits. So long as the business generates enough income to cover the installment payments (or is able to borrow the necessary funds), selling the business to an IDIT avoids gift taxes. Once the note is paid, trust assets pass to your beneficiaries tax-free. During the trust term, the installment payments provide you with a tax-free income stream.

Installment sales should be structured carefully to ensure the transaction passes muster with the IRS. Also, while the assets won't be included in

Avoiding mortality risk with a BIDIT

As noted in the main article, GRATs — and, to a lesser extent, IDITs — present some mortality risk. That is, your death before the end of the trust term will trigger certain adverse tax consequences.

To eliminate this risk, some estate planners have started using "business intentionally defective irrevocable trusts," or BIDITs. A BIDIT is similar to an IDIT, except that it's established by the business entity rather than the owner. According to its proponents, BIDITs offer tax and asset protection benefits similar (or superior) to those of an IDIT, without the mortality risk.

In essence, the idea is to have the business sell the assets. Payments are made to the business, which, as a separate legal entity, survives even after the death of its owner(s). This is designed to have the upside while eliminating the downside.

There's one important caveat, however. BIDITs are new and untested, so there's a risk that the IRS will challenge their tax benefits.

your estate if you don't survive the trust term, your estate may be subject to tax on the note's unpaid balance.

What's your succession plan?

If you own a family business, it's critical to have a succession plan that covers both the transfer of ownership and, ultimately, the transfer of control. Bear in mind that the ownership-transfer strategies we've discussed are complex, and all of the nuances aren't covered here. So be sure to work with your tax advisor. He or she can help to determine which — if any — is appropriate for the specifics of your circumstances. Whether you use these tools or other techniques, your tax advisors can help you design a plan that meets your business, financial and estate planning needs. ☺

529 plans: Fund college costs the tax-advantaged way

If you're a parent or grandparent of minor children, you're likely thinking about their future college educations and the best way to fund them. For many taxpayers, the answer is a Section 529 college savings plan, because of the potential tax advantages it offers.

The lowdown

529 college savings plans, sponsored by states, allow you to make cash contributions to a tax-advantaged investment account.

Although contributions to a Sec. 529 college savings plan aren't tax deductible at the federal level, earnings can grow tax-deferred and may be withdrawn free of federal and, generally, state income taxes, provided they're used for qualified higher education expenses. These include tuition, fees, books, supplies and equipment, and certain room and board expenses. Nonqualified withdrawals are subject to taxes and a 10% penalty on the earnings portion.

Although most college savings plans are open to both residents and nonresidents of the state sponsoring the plan, there may be advantages to opening an account in your home state: possible state income tax deductions or other state tax breaks.

529 plans are designed to fund college expenses, but they also provide estate planning benefits.



savings vehicles. The tax code doesn't specify a dollar limit; it simply requires plans to "prevent contributions ... in excess of those necessary to provide for the qualified higher education expenses of the beneficiary." Limits vary by plan, but in general, they range from \$150,000 to more than \$350,000 per beneficiary.

Other pluses

529 plans are designed to fund college expenses, but they also provide estate planning benefits. Contributions are considered completed gifts for purposes of gift and generation-skipping transfer (GST) taxes, but they're also eligible for the annual exclusion, which currently shields up to \$14,000 per year (\$28,000 for married couples) in gifts, to any number of beneficiaries, from gift

Perhaps the biggest advantage of 529 plans is that their contribution limits are much higher than those for other tax-advantaged educational

and GST taxes without using up any of your lifetime exemptions.

What's more, a 529 plan allows you to "front-load" contributions. This means that you can use up to five years' worth of annual exclusions in one year. Suppose that a husband and wife open 529 plans for their two grandchildren, and that each plan has a \$150,000 contribution limit. The couple can immediately contribute \$140,000 ($5 \times \$28,000$) to each plan *free of gift and GST taxes*.

For estate tax purposes, 529 plans are a great tool because contributions and future earnings are excluded from your taxable estate despite the fact that you retain a great deal of control over the funds. Typically, you can't place assets beyond the reach of estate taxes unless you relinquish control (by placing them in an irrevocable trust, for example). But with a 529 plan, you retain the ability to time distributions, to change beneficiaries or plans (subject to certain limitations) or even to revoke the plan and get your money back (again, subject to taxes and penalties).

Deferred compensation

Are you in compliance with Sec. 409A?

As the IRS steps up its audit activity for compliance on Internal Revenue Code Section 409A, it's a good idea for businesses to review their deferred compensation plan documents and practices.

The IRS announced last year a limited audit initiative to evaluate compliance with Sec. 409A, which prohibits deferred compensation arrangements that give participants (including employees,

The drawbacks

As great as 529 plans sound, they do have some drawbacks. One is that you're limited to the investment options the plan offers. Another is that you can change investment options only twice a year (up from once a year in 2014) or if you change beneficiaries. But anytime you make a *new* contribution, you can choose a different investment option for that contribution.

There are also a couple of estate planning drawbacks. First, if you front-load contributions, you can't make additional annual exclusion gifts to those beneficiaries for five years. Second, if you die within five years after making these contributions, a portion of them will be included in your taxable estate.

Right for your situation?

If you're interested in putting away money for your children's or grandchildren's college educations, 529 plans merit a look. They can be especially beneficial if income or estate taxes are a concern. Work with your tax and financial advisors to choose the most appropriate plan for your situation. ☺

directors and independent contractors) undue control over the timing of benefits. Violations can subject participants to immediate taxation of vested benefits plus a 20% penalty and interest.

The requirements

Congress enacted Sec. 409A more than 10 years ago in response to scandals involving Enron and other corporations. The section applies to most

nonqualified deferred compensation arrangements, including bonus plans, supplemental executive retirement plans, certain severance pay plans, and equity-based incentive compensation plans — such as stock options, stock appreciation rights (SARs) and phantom stock.

The requirements don't apply to *qualified* retirement plans (such as 401(k) plans) or to most welfare benefit plans (such as vacation, sick leave, compensatory time, disability and death benefit plans). Also exempt are short-term deferrals (bonuses paid within 2½ months after year end, for example) and undiscounted stock options and SARs. (See “Stock valuations.”)

For covered arrangements, Sec. 409A governs the timing of deferral elections and restricts the ability of participants to alter the form or timing of the payments. The law and regulations in this area are complex, but here's a quick summary of the main requirements:

- ⊙ Employees must make deferral elections *before* the beginning of the year in which they earn the compensation being deferred (except for certain performance-based compensation).
- ⊙ Benefits must be paid either: 1) on a specified date, 2) according to a fixed payment schedule, or 3) upon the occurrence of a specified event, such as death, disability, termination of employment, change in ownership or control of the employer, or an unforeseeable emergency.
- ⊙ Sec. 409A prohibits plans under which the CEO or board of directors has discretion over the timing or form of payment of vested benefits.
- ⊙ Once compensation is deferred, payments can be delayed (by five years or more) but not accelerated. Elections to delay benefits (or change the form of payment) must be made at least 12 months in advance.

In addition, employers must maintain written plan documentation that's consistent with Sec. 409A's requirements.

Stock valuations

As noted above, undiscounted stock options and SARs — that is, those with an exercise price that equals or exceeds the stock's grant-date fair market value — are exempt from Sec. 409A. Because a plan that requires participants to elect in advance when they'll exercise their rights is unworkable, most stock options and SARs are issued at fair market value to avoid Sec. 409A's requirements.

The best way to ensure that your plan falls within the exemption is to have your company's stock valued periodically by a qualified, independent appraiser.

Review your compensation program

Given the complexity of Sec. 409A and its regulations, it's important to review your deferred compensation plans for compliance. If you discover errors in a plan's documentation or operations before the IRS commences an audit, you may be able to reduce or even eliminate penalties by participating in one of the IRS's voluntary correction programs. ⊙



tax TIPS

IRS announces transition rule for IRA rollovers

An IRA rollover allows you to withdraw IRA funds tax-free, provided you reinvest the funds in the same or another IRA within 60 days. You're allowed one rollover in any one-year period.

Until recently, it was generally agreed that the one-rollover-per-year limit applied separately to each of a taxpayer's IRAs. But in a 2014 decision, the U.S. Tax Court held that the rule applies on an *aggregate* basis. In other words, you can't make more than one tax-free 60-day rollover in a one-year period, even if the rollovers involve different IRAs.



The rule took effect on Jan. 1, 2015, but the IRS established a transition rule for 2015. In Announcement 2014-32, the IRS said that, in determining whether a 2015 distribution can be rolled over tax-free, it will disregard 2014 rollovers that involved different IRAs.

For example, suppose you have two IRAs, IRA 1 and IRA 2, and that you took a distribution from IRA 1 in July 2014 and returned the same amount to IRA 1 in August 2014. Under the transition rule, you can take a tax-free distribution from IRA 2 in June 2015, provided you roll it back into IRA 2 (or into a third IRA) within 60 days. ☺

Are government settlement payments deductible?

Generally, legal settlements paid by your business are tax deductible as ordinary and necessary business expenses, but government fines and penalties aren't deductible. If you're involved in settlement negotiations with a government agency, ask for a provision in the settlement agreement characterizing your payments for tax purposes. To the extent your payments can be characterized as compensatory damages rather

than fines or penalties, you'll enjoy tax deductions that can soften the financial impact. ☺

Health care: Watch out for "skinny" plans

Employers subject to the shared-responsibility provision of the Affordable Care Act are required to offer employees "minimum essential health coverage" or risk a tax penalty. To meet this requirement, many employers are considering so-called "skinny" plans. These low-cost plans satisfy the basic requirements for minimum essential coverage but provide little or no coverage for in-patient hospitalization services or physician services. Although these plans appear to be allowed by current regulations, the IRS is expected to issue proposed regs that would prohibit this strategy — and may have done so by the time you're reading this. Check with your tax advisor for the latest information.

Under the proposal, a health plan that excludes substantial coverage for in-patient hospitalization or physician services (or both) won't comply with ACA requirements, exposing an employer to penalties. ☺