tax IMPACT

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A great time for a GRAT
How to transfer more to
your heirs at a lower tax cost

Don't "wage" war with the IRS
Review S corporation compensation
to help ensure it will pass muster

Is tax-free investing really tax free?

Tax Tips
Hobbies vs. second businesses,
tenancy-in-common (TIC) interest, and
tax-saving strategies for the self-employed

A great time for a GRAT

How to transfer more to your heirs at a lower tax cost

If you've graduated beyond making annual exclusion gifts and are looking to do more, perhaps a grantor retained annuity trust (GRAT) would fit your needs. Although it's a relatively sophisticated strategy, when carefully planned and executed, the GRAT could allow you to transfer substantial amounts of wealth to your children or other heirs while minimizing — or even eliminating — gift and estate taxes. And, by establishing a long-term GRAT while interest rates are low, you can enhance the GRAT's tax-saving potential.

What is a GRAT?

A GRAT is an irrevocable trust that pays you an annuity during its term. At the end of the term, whatever is left — known as the remainder interest — goes to your beneficiaries. The annuity is a fixed dollar amount, stated as a fixed percentage of the initial value of the assets you use to fund the trust.

A GRAT is considered a grantor trust, which means that you continue to be treated as the owner for income tax purposes and are required to pay income taxes on the trust's earnings. From an estate planning perspective, this is a significant advantage: Because taxes are paid from your separate funds rather than from the trust assets, a greater portion of the trust stays invested. In effect, by paying the income tax, you get to make additional tax-free gifts to the trust's beneficiaries. But this isn't the main tax benefit.

How does it save taxes?

When you establish a GRAT, you're making a taxable gift to the trust beneficiaries. The gift amount is determined by the present value of the expected remainder interest, which is equal to the initial value of the trust minus the present value of the annuity payments. The present value is determined by using the Section 7520 rate — an assumed rate of return the IRS publishes each month — in effect during the month the trust is established.

Even if a GRAT "fails," it doesn't mean you've lost the assets you placed in the trust. It simply means that you've failed to shelter those assets from gift and estate taxes.

The higher you set the annuity payments, the smaller the remainder interest and, therefore, the smaller the gift tax. If you set the annuity high enough so that the present value of the payments is equal to the initial value of the trust, the remainder drops to zero and there's no taxable gift at all. This is known as a "zeroed-out" GRAT.

Does that mean your beneficiaries receive nothing? Not if the trust's investments outperform the Sec. 7520 rate. In that case, those additional earnings pass to your beneficiaries free of income and estate tax. For this reason,

you want to fund your GRAT with assets you expect to grow faster than the Sec. 7520 "hurdle" rate. However, there are limited circumstances involving certain transfers to grandchildren and others deemed to be in your grandchildren's generation that can result in a tax bite.

Say you place $1 million in a 10-year GRAT for the benefit of your child and the applicable Sec. 7520 rate is 3%. According to IRS tables, an annuity payment of $117,231 per year will zero out the GRAT. But if the trust actually earns an average return of 7%, its value at the end of the term will be more than $347,000, all of which will be transferred to your child tax free.

Bear in mind that all of the GRAT's earnings will be reported on your income tax return throughout the term of the GRAT. Thus, you'll want to be sure that you have sufficient outside resources to pay the tax on the GRAT income or design the GRAT to enable you to use the annuity payments to pay the tax on the income related to the GRAT.

Why act now?

As of this writing, the Sec. 7520 rate is near its lowest level in history (4.2% in July 2008) and GRATs are most effective when interest rates are low. As explained above, the key to transferring wealth tax free with a GRAT is for the GRAT's investments to outperform the Sec. 7520 rate — and the lower that rate, the easier it is to beat.

A properly diversified portfolio tends to perform well over the long term, despite any short-term periods of poor performance. So by locking in a low Sec. 7520 rate now, a long-term GRAT is likely to produce substantial tax-free gifts.

What about the risks?

A GRAT involves two types of risk in addition to the risks associated with any investment strategy. First, there's the risk that you'll die before the end of the trust's term — known as mortality risk — which will require trust assets to be brought back into your estate and potentially be subject to estate taxes. Second, there's the risk that the GRAT's investments won't outperform the Sec. 7520 rate, resulting in no tax-free gifts for your beneficiaries.

It's important to recognize that, even if a GRAT "fails," it doesn't mean you've lost the assets you placed in the trust. It simply means that you've failed to shelter those assets from gift and estate taxes. In other words, you're no worse off than if you had never established the GRAT.

What about a short-term solution?

If you're still concerned about mortality risk or your investments' ability to outperform the Sec. 7520 rate in a volatile market, consider a rolling GRAT strategy. This involves a series of short-term GRATs (typically, terms of two or three years) in which each new trust is funded by annuity payments from the previous trusts. You won't lock in a low rate, but you'll minimize mortality risk.

What's more, some experts believe that, in a period of high volatility, rolling GRATs have the potential to outperform a single, long-term GRAT. Why? Because short-term GRATs are better able to capture the upside of a volatile market.

Suppose that over the next 10 years stock market returns average only 3%. If you establish a 10-year GRAT with a 3% hurdle rate, it would fail — that is, it wouldn't produce any tax-free gifts. Let's assume that returns average 10% during two of the 10 years and you use a rolling GRAT strategy. In this situation, most of the short-term GRATs would fail, but the ones established just before the two growth spurts would generate significant tax-free gifts.

Rolling the dice

The right GRAT strategy depends on several factors, including your comfort level with mortality risk and market volatility, your ability to lock in a low hurdle rate, your current income needs, and your willingness to accept the additional complexity and expense of a GRAT. Whichever strategy you choose, a GRAT is a bit of a gamble. But with significant tax-saving potential and little downside risk, it may be a gamble that you're willing to take. ◎

Don’t “wage” war with the IRS

Review S corporation compensation to help ensure it will pass muster

The payment of reasonable compensation to S corporation shareholders is high on the IRS’s list of audit concerns. That’s because S corporations that make distributions of profits in lieu of salaries to employee shareholders enjoy significant savings on employment taxes.

In recent years, auditors have been scrutinizing S corporation salaries and recharacterizing distributions of profits as wages when they feel that shareholder compensation is unreasonably low. The result: Affected businesses receive an unpleasant surprise in the form of a bill for unpaid employment taxes, plus penalties and interest.

The problem

The primary reason for electing S status is to avoid double taxation. In a traditional C corporation, profits are taxed once at the corporate level and again when they’re distributed as dividends to shareholders. An S corporation, on the other hand, is a pass-through entity. This means that each shareholder pays income tax on his or her share of the corporation’s profits, whether it’s distributed or not.

The traditional structure gives C corporations a strong incentive to pay healthy salaries. Wages are deductible as a business expense, so each dollar you take out of the corporation in the form of compensation means one less dollar exposed to double taxation.

In determining what’s reasonable, look at each employee’s role and duties in the company, the business’s financial condition, and compensation surveys showing salaries paid by comparable companies for similar services.

In contrast, S corporations have an incentive to minimize or even eliminate salaries for shareholders who work in the business and instead share corporate profits with them as distributions. From an individual income

Employment taxes on hypothetical S corporation owners’ salaries

Tax	Company’s share	Jack’s share	Jill’s share
FICA* taxes on Jack’s salary	$80,000 x 7.65% = $6,120	$80,000 x 7.65% = $6,120	
FICA* taxes on Jill’s salary	$80,000 x 7.65% = $6,120		$80,000 x 7.65% = $6,120
FUTA** on Jack’s salary	$7,000 x 6.2% = $434		
FUTA** on Jill’s salary	$7,000 x 6.2% = $434		
Total	$13,108	$6,120	$6,120

* Each party’s share of FICA consists of a Social Security tax of 6.2% on wages up to $102,000 (in 2008) and a 1.45% Medicaid tax on all wages.

** The company pays federal unemployment taxes of 6.2% on the first $7,000 of each employee’s wages. If state unemployment taxes were paid timely, the FUTA rate could be as low as .08%.

tax perspective, the form in which profits are paid out is irrelevant. But from an employment tax perspective, it makes a big difference.

Let's look at an example. Jack and Jill are the co-owners and sole employees of an S corporation, and neither one takes a salary. In 2008, the business earns $200,000 in net income, all of which is distributed to Jack and Jill in equal shares. By paying no salaries, the company avoids employment taxes. And, unlike sole proprietors and partners, S corporation shareholders who work in the business aren't subject to self-employment taxes.

The company is audited by the IRS, which recharacterizes $80,000 of each owner's distributions of profits as wages. As a result, the company and its owners are assessed a total of $25,348 in employment taxes (not including interest and penalties), as shown in "Employment taxes on hypothetical S corporation owners' salaries" on page 4.

Fortunately, the company's share of employment taxes is deductible as a business expense, reducing Jack and Jill's tax liability to some extent.

The solution

S corporations that pay little or no salary to employee shareholders are handing the IRS a major red flag. And if you make no effort to establish reasonable salaries, the IRS will make its own determination — based on limited knowledge about your business.

To prevent such a result, conduct your own analysis, establishing and documenting reasonable salaries for each position. In determining what's reasonable, look at a variety of factors, including each employee's role and duties in the company, the business's financial condition, and compensation surveys showing salaries paid by comparable companies for similar services.

Some S corporations use a formula to allocate shareholder payment — for example, 60% salary and 40% distributions of profit. Although this approach is less likely to garner the IRS's attention than paying no salary at all, it's still risky. If you're audited and you can't support your allocation based on each employee's actual role in the company, the agency might still recharacterize some of the distributions of profits as wages.

Do your homework

Unfortunately, there's no way to guarantee that the salaries you set will pass muster with the IRS. But if you do your homework and show that you've made a good faith effort, the agency is more likely to defer to your judgment. Paying a salary equal to the Social Security wage base will help reduce your risk of reclassification. ◎

Is tax-free investing really tax free?

Investing in tax-exempt securities such as municipal bonds can be a great strategy, especially if you're in a high tax bracket. But this strategy can backfire if you're not careful. Sometimes "tax free" isn't as free as it seems.

Compare apples to apples

Municipal bonds are debt securities issued by state and local governments to finance public works projects, such as schools and roads. Interest on these bonds is generally exempt from federal income taxes and, depending on where you live and where the bond was issued, can be exempt from state and local taxes. Note that the exemption is limited to interest income — it doesn't apply to any capital gains from the sale of municipal bonds.

The fact that an investment is tax exempt doesn't necessarily mean that it's a better choice than a comparable taxable investment. Municipal bonds, for example, typically offer lower yields than comparable corporate bonds. To compare apples to apples, calculate the tax-equivalent yield, which incorporates tax savings into the municipal bond's yield. The formula is simple: Tax-equivalent yield = actual yield/(1 – your marginal tax rate).

Suppose, for instance, you're considering a municipal bond with a 4.5% yield and a comparable corporate bond that offers a 6.25% yield. If you're in the 35% tax bracket, the municipal bond's tax-equivalent yield would be .045/(1 – .35) = .069, or 6.9%. In terms of the amount of income you get to keep, the municipal bond is the better choice. And if the municipal bond is also exempt from state and local taxes, the tax advantage is even greater.

What if you're in the 25% tax bracket? Assuming no state or local tax savings, the tax-equivalent yield would be .045/(1 – .25) = .06, or 6%. In that case, the corporate bond would offer the greater return.

Watch out for tax traps

The tax-equivalent yield is critical, but it may not tell the whole story. So be sure to consider the impact of your investment strategies on other aspects of your tax return.

One tax trap is the effect of interest on taxable bonds on your eligibility for deductions or other tax benefits that are reduced or phased out above certain income levels. For example, the taxable bond's interest could cause your adjusted gross income to be increased, resulting in a reduction of certain deductions, such as medical expenses or miscellaneous deductions, which are reduced as income increases.

Another potential tax trap involves Social Security. Even though municipal bond interest is tax exempt, it counts as part of your income for purposes of determining the taxable portion of Social Security benefits. The IRS looks at your "provisional income," which is your modified adjusted gross income plus nontaxable interest (which includes municipal bond interest) plus one-half of your Social Security benefits. If the total exceeds $25,000 ($32,000 for joint filers), up to 85% of your Social Security benefits will be taxable.

Look at the big picture

Tax-free investments have obvious appeal, but it's important to analyze them in light of your overall tax picture. And, as with any investment, it's important to consider factors other than taxes, such as credit quality, price volatility and the investment's role in your asset allocation strategy. ◎

tax TIPS

Hobby or second business?

If you invest a lot of time and effort in an activity other than your primary profession — music or woodcrafts, for example — it pays to examine whether the IRS considers the activity to be a hobby or a second business. Because this is an area of focus for the IRS, your risk of getting audited is significantly increased.

In making its determination, the agency looks at several factors, including whether:

- The activity is carried on in a businesslike manner,
- The time and effort you put into the activity indicates you intend to make it profitable, and
- You depend on income from the activity for your livelihood.

If an activity qualifies as a hobby, your expenses are deductible only to the extent of any hobby income. But if it qualifies as a business, you may be able to deduct losses against your salary or other income. ◎

TIC funds can be a common-sense exit strategy

Exchanging real estate for a tenancy-in-common (TIC) interest may be a strategy for diversifying your portfolio, boosting your income and ridding yourself of management burdens without negative tax consequences.

A TIC interest is simply an undivided fractional interest in real estate that, if properly structured, qualifies as like-kind property under Section 1031. There are a variety of TIC funds that offer professional management and an opportunity to invest in high-yield, institutional-grade properties ordinarily unavailable to a single investor.

Keep in mind that TIC funds may be subject to a minimum investment requirement and often impose holding periods that limit your liquidity. And these funds must be structured carefully to avoid having the IRS reclassify the fund as a partnership that's ineligible for Sec. 1031 treatment. So be sure to investigate a fund thoroughly and consult your tax advisor before you enter any transaction. ◎

The art of self-defense

If you're self-employed, there are many moves you can make before year end to reduce your 2008 tax bill. Here are a few ideas:

Contribute to a retirement plan. For 2008, you can contribute up to 25% of your net compensation (20% of self-employment income if you're a sole proprietor), or $46,000, whichever is less, to a SEP-IRA or a profit-sharing plan. The contribution limit for a solo 401(k) plan is $15,500 ($20,500 for individuals age 50 or older) plus a profit-sharing contribution of $30,500. You have until your tax return due date (including extensions) to establish and make tax-deductible contributions to a SEP-IRA. Solo 401(k) and profit-sharing plans also allow you to make contributions as late as your extended tax-filing deadline, but these plans must be set up by year end.

Take a Section 199 deduction. Internal Revenue Code Sec. 199 allows qualifying businesses — including sole proprietorships — to deduct 6% of their income from qualified domestic production activities. Although the deduction is usually associated with manufacturing, many other types of businesses qualify (including construction, engineering, architecture and film production). ◎

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