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Tax & Business Alert

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KNOW YOUR OPTIONS FOR BUSINESS INTEREST TRANSFERS

Business owners should always know their options when it comes to their company and its relation to their estate plans. Let's take a look at some commonly chosen vehicles for transferring ownership interests in a business.

THE GREAT GRAT

With a grantor retained annuity trust (GRAT), you transfer business interests or other assets to an irrevocable trust. The trust then pays you a fixed annuity for a specified number of years, and at the end of the trust term the trust assets are transferred to your children or other beneficiaries free of any additional gift tax, even if the property has appreciated while held in trust.

GRATs offer several important advantages. Gift tax is based on the actuarial value of your beneficiaries' future interest in the trust assets at the time the trust is funded. Depending on the size of the annuity payments and the length of the term, this value can be very low and can even be "zeroed out." Also, you remain in control of the business during the trust term. And the annuity payments provide a source of income to fund your retirement or other needs.

Keep in mind that for a GRAT to succeed you *must* survive the trust term, and your business must generate enough income to cover the annuity payments. Also, be aware that legislation has been proposed that would limit the benefits of a GRAT.

THE INTRIGUING IDGT

An intentionally defective grantor trust (IDGT) is an irrevocable trust designed so that contributions to the trust are considered completed gifts for gift and estate tax purposes even though the trust is considered a "grantor trust" for income tax purposes. (That's the "defect.") But the trust is very effective because the trust assets won't be included in your estate. Selling your business to an IDGT, rather than giving it to your beneficiaries outright, allows you to retain control over the business during the trust term while still enjoying significant tax benefits.

Maintaining grantor trust status is important for two reasons: First, *you* pay income taxes on the trust's earnings. Because those earnings stay in the trust rather than being used to pay taxes, you're essentially making additional tax-free gifts to your beneficiaries. Second, because a grantor trust is considered your "alter ego" for income tax purposes, distributions you receive from the trust generally will be tax-free.

4 MORE OPTIONS FOR TRANSFERRING OWNERSHIP INTERESTS

In addition to GRATs and IDGTs (see main article), there are several other options for transferring family business interests to the younger generation, including:

1. **Outright gifts.** If you're willing to relinquish control, you can transfer substantial interests tax-free using the $5.45 million exemption.
2. **Installment sales to family members.** These offer significant gift and estate tax savings, provided you're ready to part with the business.
3. **Self-canceling installment notes.** These require the buyer to pay a significant premium. But, if the seller dies before the note is paid off, the remaining payments are canceled without triggering additional gift or estate taxes.
4. **Family limited partnerships.** These arrangements enable you to transfer large interests in the business to family members at discounted gift tax values, while retaining management control. The IRS does scrutinize them closely, however.

THE NEED FOR A PLAN

For business owners, strategic planning and estate planning should go hand in hand. To achieve your goals, develop an integrated approach that addresses ownership and management succession issues together with estate planning issues. For help gathering the right information and making the best choice for you, please contact us. ■

ARE YOU *SURE* YOU WANT TO TAKE THAT 401(K) LOAN?

With summer headed toward its inevitable close, you may be tempted to splurge on a pricey "last hurrah" trip. Or perhaps you'd like to buy a brand new convertible to feel the warm breeze in your hair. Whatever the temptation may be, if you've pondered dipping into your 401(k) account for the money, make sure you're aware of the consequences before you take out the loan.

PROS AND CONS

Many 401(k) plans allow participants to borrow as much as 50% of their vested account balances, up to $50,000. These loans are attractive because:

- They're easy to get (no income or credit score requirements),
- There's minimal paperwork,
- Interest rates are low, and
- You pay interest back into your 401(k) rather than to a bank.

Yet, despite their appeal, 401(k) loans present significant risks. Although you pay the interest to yourself, you lose the benefits of tax-deferred compounding on the money you borrow.

You may have to reduce or eliminate 401(k) contributions during the loan term, either because you can't afford to contribute or because your plan prohibits contributions while a loan is outstanding. Either way, you lose any future earnings and employer matches you would have enjoyed on those contributions.

Loans, unless used for a personal residence, must be repaid within five years. Generally, the loan terms must include level amortization, which consists of principal and interest, and payments must be made no less frequently than quarterly.

Additionally, if you're laid off, you'll have to pay the outstanding balance quickly — typically within 30 to

90 days. Otherwise, the amount you owe will be treated as a distribution subject to income taxes and, if you're under age 59½, a 10% early withdrawal penalty.

HARDSHIP WITHDRAWALS

If you need the money for emergency purposes, rather than recreational ones, determine whether your plan offers a hardship withdrawal. Some plans allow these to pay certain expenses related to medical care, college, funerals and home ownership — such as first-time home purchase costs and expenses necessary to avoid eviction or mortgage foreclosure.

Even if your plan allows such withdrawals, you may have to show that you've exhausted all other resources. Also, the amounts you withdraw will be subject to income taxes and, except for certain medical expenses or if you're over age 59½, a 10% early withdrawal penalty.

Like plan loans, hardship withdrawals are costly. In addition to owing taxes and possibly penalties, you lose future tax-deferred earnings on the withdrawn amounts. But, unlike a loan, hardship withdrawals need not be paid back. And you won't risk any unpleasant tax surprises should you lose your job.

THE RIGHT MOVE

Generally, you should borrow or take hardship withdrawals from a 401(k) only in emergencies or when no other financing options exist (and your job is secure). For help deciding whether such a loan would be right for you, please call us. ■

HOW TO ASSESS THE IMPACT OF A CHILD'S INVESTMENT INCOME

When they're old enough to understand the concepts, some children start investing in the markets. If you're helping a child learn the risks and benefits of investments, be sure *you* learn about the tax impact first.

POTENTIAL DANGER

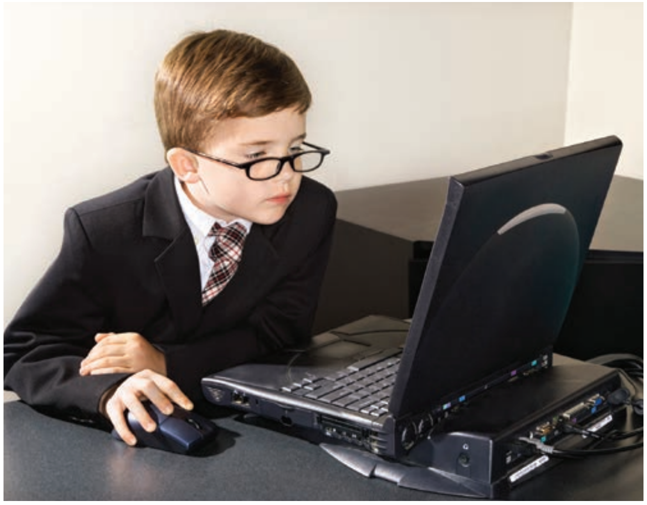
For the 2016 tax year, if a child's interest, dividends and other unearned income total more than $2,100, part of that income is taxed based on the parent's tax rate. This is a critical point because, as joint filers, many married couples' tax rate is much higher than the rate at which the child would be taxed.

Generally, a child's $1,050 standard deduction for unearned income eliminates liability on the first half of that $2,100. Then, unearned income between $1,050 and $2,100 is taxed at the child's lower rate.

But it's here that potential danger sets in. A child's unearned income exceeding $2,100 may be taxed at the parent's higher tax rate if the child is under age 19 or a full-time student age 19–23, but not if the child is over age 17 and has earned income exceeding half of his support. (Other stipulations may apply.)

SIMPLIFIED APPROACH

In many cases, parents take a simplified approach to their child's investment income. They choose to include their son's or daughter's investment income on their own return rather than have him or her file a return of their own.



Basically, if a child's interest and dividend income (including capital gains distributions) total more than $1,500 and less than $10,500, parents may make this election. But a variety of other requirements apply. For example, the unearned income in question must come from only interest and dividends.

MANY LESSONS

Investing can teach kids about the time value of money, the importance of patience, and the rise and fall of business success. But it can also deliver a harsh lesson to parents who aren't fully prepared for the tax impact. We can help you determine how your child's investment activities apply to your specific situation. ■

HEADS UP! ITEMIZED DEDUCTIONS MAY BE AHEAD

Year end may seem far away. But now's a good time to start looking ahead to what itemized deductions you may be able to claim for the 2016 tax year.

Following is a list of selected deduction and exclusion items to consider. Don't use the list as a tax planning worksheet. Rather, think of it as an exercise to help with your tax planning efforts and a good conversation starter for the next time we visit. Bear in mind that various limitations may apply to the items listed.

DEDUCTIBLE UNREIMBURSED EMPLOYEE EXPENSES

- Business travel expenses.
- Business education expenses.
- Professional organization or chamber of commerce dues.
- License fees.
- Impairment-related work expenses.
- Depreciation on home computers your employer requires you to use in work.

DEDUCTIBLE MONEY MANAGEMENT COSTS

- Tax preparation fees.
- Depreciation on home computers used to produce investment income.
- Investment interest expenses.
- Dividend reinvestment plan service charges.
- Loss of deposits due to financial institution insolvency.

DEDUCTIBLE PERSONAL EXPENDITURES

- Income, real estate and personal property taxes (state, foreign and local).
- Medical and dental expenses.
- Qualifying charitable contributions.
- Personal casualty and theft losses.

INCOME EXCLUDABLE FROM TAXABLE INCOME

- Health and most life insurance proceeds.
- Military allowances and veterans benefits.
- Some scholarship and grant proceeds.
- Some Social Security benefits.
- Workers' compensation proceeds. ■