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**ESTATE PLANNING**

**Double-dipping for Income and Estate Tax Savings**

Many retirees, when updating their wills or trusts, will often carve out a specific bequest to a favorite charity. For example, the will might direct \$50,000 or \$100,000 to a favorite church or a hospital, and the residual of the estate is split equally among the children. Bequests such as these directed to charity reduce the taxable estate of the donor, and that portion of the net worth is free of any estate tax. But because it is a post-death transfer, there are no income tax savings.

But for many, there is a better alternative. If the retiree's commitment to that charitable entity is rock solid, consider initiating the transfer during lifetime with a charitable gift annuity. This strategy produces an income tax deduction and enhances income during retirement years.

***The charitable gift annuity***

A charitable gift annuity is a contractual arrangement between a donor and a charity. The donor transfers cash or other assets to the charity, and receives an annuity from the charity that is payable for lifetime. Married donors will generally structure the annuity to pay as long as either spouse is living. Charitable gift annuities are generally considered to bring three advantages: 1) greater income during retirement, 2) a charitable income tax deduction at inception, and 3) a retirement annuity that is partially tax free. The major disadvantage, of course, is that there is no residual inheritance for the children. But that is the same outcome that would have occurred with the post-death charitable bequest through the will or trust.

***Enhanced income***

Most charities that offer gift annuities use the rates established by the American Council on Gift Annuities. The rates are based on the age of the annuitant at the inception of the contract, with

the rates varying based on whether the annuity is payable over one life or two lives. Here are some sample payout rates for a one-life annuity:

<u>Age</u>	<u>Payout %</u>
66	5.8%
70	6.1%
76	6.9%
82	8.0%

Annuities that pay out for two lives will have a lower percentage, based on the greater longevity of two recipients. Here are several illustrations of the current two-life rates:

<u>Ages</u>	<u>Payout %</u>
70-70	5.6%
75-75	6.0%
80-75	6.2%
80-80	6.6%

For many retirees, the current low interest rate on investments, as well as the fluctuations in the stock market, have produced diminished income. These gift annuity rates present an opportunity to lock in a solid cash flow that won't fluctuate.

### ***Charitable income tax deduction***

Because an individual who commits to a charitable gift annuity has made a permanent transfer for the benefit of a charity, a charitable deduction is allowable at the inception of the agreement. The charitable deduction will vary based on the age and income payback to the individual, but generally is about 30%-45% of the value of the property transferred in exchange for the annuity. This large income tax deduction can be a significant advantage to the donor, and represents a deduction not available if residual wealth is simply bequeathed to a charity after death.

### ***Partially tax-free income***

Another advantage of a charitable gift annuity is that the income stream is generally only partially taxable. Part of each annuity payment is considered return of the donor's tax basis in the property. The portion that is tax free depends on the individual's age and duration of the payments, the payback rate, and the IRS interest rate at inception. Here's an illustration:

#### ***Example***

Art, age 72, holds several publicly traded stocks worth \$100,000, and he is concerned about the fluctuations in value and possible decline in their market price. The stocks have a tax basis of only \$30,000, and would trigger a significant gain if Art sold them. Instead, Art transfers the \$100,000 of securities to a charity, in exchange for a gift annuity that pays Art 6.3% for lifetime (\$6,300 annually, or \$1,575 per quarter). Upon

entering into this transaction, Art has no capital gain from disposition of the securities. Rather, he receives a charitable deduction of about \$42,000.

Because Art's transfer was appreciated capital stock, this \$42,000 charitable deduction is limited to 30% of Art's adjusted gross income in his Form 1040 each year. If Art's annual 1040 income is \$60,000, he claims an \$18,000 charitable deduction (30% x \$60,000). Any excess charitable deduction carries forward to future years, subject to a 5-year limit. Under these rules, it would take Art three tax years to fully consume the \$42,000 deduction.

Art's annual annuity of \$6,300 is only partially taxable. Approximately \$1,200 is tax free each year, about \$2,800 represents capital gain, and about \$2,300 is ordinary income. By entering into this gift annuity arrangement, Art has improved his annual cash flow, converted his stocks into an asset producing a steady income stream, and also created a large charitable income tax deduction to benefit his Form 1040.

Charitable gift annuities are attractive to those who want a stable income that they cannot outlive. If the donor is already committed to making a post-death gift to charity, the gift annuity simply accelerates the commitment. But it also brings the added benefits of an income tax charitable deduction and an enhanced retirement cash flow.

Charitable gift annuities are ideal for even those doing smaller charitable transfers, as they are transacted with little or no overhead. The charity simply must have an established charitable gift annuity program. For those considering larger transactions, a Charitable Remainder Trust (CRT) provides essentially the same benefits. But it has the added advantage of flexible design to specifically fit the donor's objections and tax situation. Please let us know if we can assist with either of these strategies.

## **Dealing with that Valuable Vacation Property**

Estate planners are well-versed in strategies to assist an individual in moving a family business to a successor-child, while also providing an equitable share of the estate to the non-business children. In these situations, an overriding principle is that the business goes to those involved, and we don't create the risk of future family discord by giving business interests to those heirs not involved in the business.

But what about that valuable \$1.5 million vacation property? Mom and Dad have that lake home, waterfront condo, or other vacation property that the entire family enjoys and cherishes. How should we pass that valuable asset on to three children without the risk of a financial or family blow-up down the road?

Here are three alternatives that those in this situation might find of interest:

**1. *The “no plan” plan.***

This strategy treats the vacation home like any other residual asset: All children share equally. Assuming that they agree to retain the asset, the three children would each have an undivided one-third title to the property, and would share equally in the annual overhead of real estate taxes and maintenance. Presumably, they work out a plan to share its use, can agree on the big decisions of capital improvements and major repairs, and things work well—at least in the short run.

Now roll ahead 10 or 15 years, and the situation has evolved. One child is likely a very active user and has probably assumed most of the decision-making and, perhaps, the financial cost of repairs and other discretionary expenditures. Another child might be an occasional user and contributor to the overhead. But it is likely there is at least one child who rarely, if at all, uses the property, and has become increasingly resentful of the asset that belongs to the siblings. And that child likely has a spouse regularly pointing out that they own a multi-million dollar vacation property that they get no benefit from, incur some annual tax and assessment charges, and wouldn't it really be better if we simply cashed out?

So now the fun begins: All of the family emotions get in the way of that purchase-sale transaction. The siblings are in a position of being adversarial negotiators to a difficult transaction. They may work it out without the need for expensive appraisals and legal costs, but the process will likely be contentious to the point that they aren't getting together anymore as a family for those Thanksgiving dinners!

**2. *The entity approach.***

Under this strategy Mom and Dad direct, within their will or trust, that the valuable vacation property will be placed in a partnership or similar entity. The children do not inherit a direct interest in the real estate, but rather an interest in a partnership that has a governing document. The key difference is that each child's ownership is subject to the terms of that partnership agreement.

This agreement can cover everything from annual operating matters, such as an annual contribution to provide funds for taxes and maintenance. It may also designate one or more children to serve as manager to handle the day-to-day decisions. Most importantly, the agreement can provide buy-out terms (e.g. secure two appraisals, average those appraisals, apply a small discount, and structure payments to a departing owner over a specified period of time at a reasonable interest rate). These buy-out terms can eliminate much of the negotiating tension between the siblings, and not place an undue financial burden on those who remain as owners.

This plan is better, but recognize that there may still be some tension to the timing and payout arrangement if one child presses for a sale at a point that is difficult for the remaining owners.

**3. *The “no-sell” solution.***

The following approach was recently executed by a retired executive with a valuable vacation property. Following the deaths of Mom and Dad, the vacation property goes into a trust arrangement for the benefit of the children. In addition to placing the vacation property into the trust, an additional sum of money is transferred. This capital, when invested, is to provide a source of funds to cover the taxes and repairs and, perhaps, even occasional major improvements, so that the overhead of maintaining the property is not a burden on any of the children, regardless of their financial circumstance.

The operating decisions rest with independent trustees (such as an independent trust department or other family members). The children will advise the trustee regarding necessary improvements and maintenance, but independent judgment is in control.

However, the key difference in this plan comes when a child wishes to cash out, potentially tripping that contentious buyer-seller relationship. The trust specifically prohibits any sale of an interest. In fact, the children and their heirs are beneficiaries only to the extent of the use of the property. Ultimately, if the users all decide to sell because of disinterest and lack of use of the property, the sale proceeds are mandatorily bequested to a charity.

This unusual approach of any sale proceeds directed to charity assures that no child can convert their share of the vacation property into other wealth. The vacation property has only one benefit: its ongoing use and enjoyment by family members and their descendants. Ultimately, when that use and enjoyment diminishes many years down the road, the children will not be in an adversarial financial position. There will be no financial incentive to cash out, which likely encourages continued use and enjoyment within the family for many years.

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## **BUSINESSES**

### **S corporations and Inadequate Compensation**

For small businesses, it seems clear that S corporations are the entity of choice. Even though the tax law now allows up to 100 shareholders in an S corporation, recent IRS statistics indicate that 84% of S corporation entities have only one or two shareholders. In fact, the number of S corporations with 11 or more shareholders is a mere 1% of the total S corporation filings.

In a recent report by the Taxpayer Advocate Service to Congress, the popularity of S corporations was noted. This report observed that sole proprietors may incorporate to gain limited liability, and they likely favor the flow-through reporting structure of an S corporation.

#### ***Taxation of S corporations***

An S corporation, unlike a C or regular corporation, does not separately pay tax. Rather its income or loss flows through to the shareholders, and that net income or loss is taxable in the Form 1040 of the owners.

However, the recent report to Congress noted that S corporations have a key advantage: Any S corporation net earnings are not subject to self-employment tax. This arguably makes S corporations superior to proprietorship and partnership tax treatment.

But the IRS has also noted that this difference in treatment gives rise to a possible tax abuse. Individuals who are both employees and shareholders of S corporations, particularly small one- or two-person entities, will take no salary or perhaps only nominal salary, and withdraw the remaining earnings as distributions that are free of payroll or self-employment tax. The S corporation avoids its share of the payroll taxes, and the individual shareholder only incurs income tax, not Social Security or self-employment tax, on the S corporation earnings.

The Treasury Inspector General for Tax Administration cautioned the IRS and Congress about this strategy, noting that almost one million S corporations with one shareholder had paid no officer's compensation. While some of those entities legitimately may have had no services rendered by the shareholder, others may be abusing the ability to have S earnings flow to the owner without payroll taxes.

#### ***IRS court challenges***

The IRS has regularly challenged and defeated S corporation shareholders on this wage issue in court. As the recent report to Congress noted, establishing a fair and reasonable wage is

difficult, and requires the consideration of a number of factors. The courts will review the time worked by the shareholder, the salary structure in similar industries and businesses, the rate of return that the shareholder received on investment, the financial condition of the corporation, and similar factors.

### *Implications*

With the Treasury Inspector General and the Taxpayer Advocate both sounding the same alarm, it would seem clear that change is in the wind. The Taxpayer Advocate suggests increased compliance efforts by the IRS in scrutinizing owner compensation from closely-held S corporations.

The IRS, from its viewpoint, would rather see Congress adjust the tax law to either eliminate the exemption from self-employed Social Security tax for S corporations or, alternatively, put some limitation in place on the exemption. Any legislative change is unlikely within 2008, but stay tuned when we get to 2009 with a new President and new Congress.

In the meantime, for those with S corporations, give consideration to the defensibility of the compensation amount to owner-employees, and contact us if you need any assistance in evaluating the reasonableness and defensive position that you have taken on this important issue.