MILLER, MONSON, PESHEL, POLACEK & HOSHAW

A PARTNERSHIP OF PROFESSIONAL LAW CORPORATIONS

MARCH 2014 NEWSLETTER

501 WEST BROADWAY, SUITE 700
SAN DIEGO, CALIFORNIA 92101-3563
TELEPHONE: (619) 239-7777
FAX NUMBER: (619) 238-8808

SAN DIEGO MAGAZINE 2014 TOP LAWYERS

We are pleased to announce that all the partners of Miller, Monson, Peshel, Polacek & Hoshaw are being honored as "Top Lawyers" in the March issue of San Diego Magazine. San Diego Magazine uses Martindale-Hubbell's Peer Review Ratings Database, one of the most comprehensive attorney databases, to identify those lawyers who have received the highest peer rating – AV Preeminent. Our attorneys are being recognized in five different fields of expertise, demonstrating the breadth of our firm's skills and knowledge. MMPPH would like to congratulate the following attorneys for their recognition as Top Lawyers:

Litigation

Thomas M. Monson

Estate Planning

Mary J. Peshel

Business Planning

Timothy C. Polacek

Civil Litigation

Susan L. Horner

Taxation

William D. Hoshaw

To learn more, please visit San Diego Magazine.

On December 6, 2013, Drew Schlosberg, host of the U-T *Community Spotlight* radio show, interviewed Patty Cowan, CEO of the Coronado Schools Foundation, and Bradford N. Dewan. Mr. Dewan serves as a mentor to the Coronado Schools Foundation under the San Diego chapter of the Partnership for Philanthropic Planning. As a mentor, Mr. Dewan provides guidance and advice on how to grow the foundation's endowment with planned gifts from the foundation's supporters. You can listen to the two segments by clicking here and here.

IN THIS ISSUE:

LOW INTEREST RATES CONTINUE TO ENHANCE ESTATE PLANNING OPPORTUNITIES FOR GRATS AND LOANS TO CHILDREN

By Timothy Polacek

In February 2012, we advised how low interest rates enhanced the use of delayed gifting techniques such as a grantor retained annuity trust (GRAT). Prevailing interest rates at that time for future interest gifts required an assumption that assets would earn only 1.4% annually under IRC Section 7520. In situations where a parent desired to transfer a stable income asset to a child after retaining an annuity for a certain time period, a GRAT was a very viable gifting technique.

Two years later, a GRAT remains a good way to make future interest gifts because the IRC Section 7520 rate for March 2014 assumes a very low 2.2% annual interest rate of return. Although these interest rates are likely to remain low for another year or more, they are drastically low if you consider the same rate stood at 5.0% in December 2007.

Gifting Future Interests Using GRATs. Assume a parent is age 60 and has a reasonably large retirement plan that will require annual distributions to begin in 10 years. Let's further assume the parent owns an apartment building worth $1,000,000 that is subject to a triple net lease that pays 5.0% annually.

If the parent desires to transfer the apartment to take advantage of today's low interest rates, he or she could transfer the property into a GRAT for a period of 10 years and receive an annual $45,000 annuity payment. At the end of the term, the property will pass to his or her child as a completed gift valued at $555,535.

In such a GRAT transaction, the donor conveys an asset to an irrevocable trust, whose terms provide that the donor will receive an annuity payment for a fixed term. Because the grantor retains the right to income of the trust, as well as additional powers of asset substitution, the GRAT can be treated as a wholly grantor trust and not as a separate taxpayer. Also, because the donor retains the right to receive future annuity payments, the value of the deferred gift is reduced. Finally, if less than 100% of real property is gifted, additional valuation discounts ranging between 15% and 20% are often applied to the value of the gift.

The income produced by the real estate provides cash flow for the annuity obligations and future appreciation in the asset accrues outside of the donor's taxable estate, provided the donor survives until the end of the fixed period of the GRAT (otherwise the property is included in the donor's estate). In appropriate instances, to ensure full grantor trust status, the donor may want to include a "remove and replace" provision in the GRAT declaration enabling the donor to substitute property of equal value at any time during the GRAT term. Although this could require having to appraise the donated property, it gives the donor additional control over the property in case the donor later changes his or her mind and desires to keep the apartment building and substitute other property for final distribution to the child.

Although present law allows a parent to cumulatively gift up to $5,340,000 in 2014 without paying gift taxes, there may be other reasons to use a GRAT as part of an estate plan designed to identify specific assets to be transferred to future generations. Commonly cited reasons for making delayed gifts include shifting income to family members in a lower income tax bracket at the end of the GRAT term, asset protection, spendthrift protection, and succession planning for assets in which a child is a manager or which assets are otherwise earmarked as a specific bequest.

Parent-Child Loans. Suppose a parent wants to reduce his or her income taxes but does not want to make an outright gift to a child. Using March 2014 interest rates, a parent can make a loan to a child at the following interest rates:

- 3 years, at 0.28% interest
- 9 years, at 1.84% interest
- 30 years, at 3.36% interest

In situations where a child desires to acquire relatively safe assets (e.g. a first deed of trust), the parent can act as a secured lender to not only reduce the parent's taxable income, but provide family members with financial opportunities that are unlikely to be available in the future.

Of course, if a parent desires to make substantial wealth transfers, these interest rates can be used to sell assets to a child or grandchild on an "installment basis" using a secured promissory note that defers gain until the principal is repaid on the note. Using a 30 year note for such transactions based on current interest rates would provide considerable tax savings if interest rates rise substantially in the future due to perceived inflationary pressures once the Federal Reserve Bank discontinues its current quantitative easing measures.

Even better, in cases where children borrowed money years ago at high interest rates, a parent can refinance those loans based on today's lower rates. In extreme cases where a parent desires to be paid no interest, arranging an interest free loan will result in a lower than usual amount of imputed interest having to be reported by the parent to the IRS.

INTERNATIONAL TAX UPDATE

By DeEtte L. Loeffler

Tax filing season is a good time to review your reporting requirements. Assets received from foreign persons, or held in foreign accounts or entities by US persons (i.e., US citizens and residents) are subject to reporting. Failure to make those reports can subject you to substantial fines and penalties.

Foreign Gifts. While gifts are generally not subject to a federal transfer tax, some "large" gifts from "foreign persons" (i.e. a non-US Person, partnership or corporation) must be reported. A gift is considered "large" if it exceeds $100,000 (in aggregate with other gifts received from the same foreign source). Gifts from entities are indexed for inflation. Large foreign gifts must be reported on an IRS Form 3520. Failure to report a large gift from a foreign person can subject the taxpayer to penalties of 5% of the unreported gift each month the gift remains unreported (up to a total of 25%). In January, the IRS reminded taxpayers that the statute of limitations does not begin to run on foreign gifts until the report is made. Form 3520 is due with your income tax returns, IRS Form 1040.

FATCA Update. The US Government continues to enter into treaties with foreign governments to obtain information about foreign bank and investment accounts held by US Taxpayers. Foreign Account Tax Compliance Act (FATCA) went into effect in March 2010 and targets US Taxpayers who fail to report foreign assets and financial accounts. To date, the US has signed 22 Intergovernmental Agreements for bilateral reporting and 12 agreements in substance to further the goals of FATCA. The newest countries to join are The Cayman Islands, Costa Rica, Denmark, France, Slovenia, Canada and Hungary. Under FATCA, taxpayers are required to file IRS Form 8938 to report interests in foreign accounts that exceed $50,000 at year's end or $75,000 at any time during the year. Reporting is required for: foreign deposit and custodial accounts at financial institutions (including those held in grantor trusts), foreign stocks, partnerships, mutual funds, and cash value life insurance and annuities. Failure to file Form 8938 can result in a $10,000 penalty (or $50,000 for continued failure after IRS notification). Form 8938 is due with IRS Form 1040.

FBAR Update. The IRS also requires taxpayers to report interests held in foreign banks and financial institutions if those accounts exceed $10,000 at any time during the tax year. This report is made in FinCEN Form 114. The IRS imposes substantial fines for failing to comply with FBAR ($10,000 per account per year for non-wilful value to report, and the greater of $100,000 or 50% of the account balance for wilful failures). There is a six (6) year statute of limitations on FBAR reporting, but when that statute begins to run is not entirely clear. The FBAR must be filed electronically with the Financial Crimes Enforcement Network by June 30 of each year.

CASH BONUS INCENTIVE PLANS FOR KEY EMPLOYEES

By Bradford N. Dewan

As business owners and their advisors begin to discuss the medium to long term planning for their business, the topic of cash bonus plans will come up quite often. Sometimes the purpose of such a plan is to simply install a bonus plan for the key employees as a way to reward them for their performance on a year-to-year basis. In other instances, an owner may feel that a bonus plan needs to be put in place to remain competitive in the marketplace after a key employee leaves the business to work for a different company offering a higher salary. While these are a couple of valid reasons a business owner may base their decision on regarding the installation of an incentive plan for the key employees of the business, they don't reflect the most crucial reason why such plans should be adopted.

The real underlying and fundamental purpose for installing a bonus plan for certain key employees is to help the business owner reach his or her succession planning goals. While business owners may differ on when they may want to exit or "transition away" from their companies or what that exit or transition will look like, the underlying goal for each plan is very similar: to allow the business owner to leave on his or her terms and at his or her selected time. Consequently, this is the goal that any key employee incentive plan should support.

Essentially, a key employee incentive plan must be designed to support the primary succession planning goals of the owner. This is achieved by motivating the key employees to stay with the company for an extended and clearly defined period of time.

This fundamental factor is reflected in the following:

- Very few business owners take an extended vacation (much less cut back on their day-to-day involvement) without being able to leave capable management in charge to run the business;
- No sophisticated buyer will seriously consider a company that lacks a good management team that is both effective and synergistic;
- Many businesses are not sold to third-party buyers, but to one or more of the key employees of the company; and
- Transferring a family-owned business to one or more of the children will be especially risky in the absence of key employees with various skills and experience who will remain after the transition to the new owners has occurred.

In each of these cases, it is very clear that the business owner will rely on the presence of their key employees to advance and facilitate their personal exit strategy. With the realization and acknowledgement of how important the retention of key employees is to the success of any type of business succession plan, the focus can now turn to the structure of a key employee incentive plan.

For an incentive plan to be effective, it must contain an incentive formula that will reward the key employees as their efforts increase the value of the business. Stated a bit differently, an effective key employee incentive plan increases the value of the business while simultaneously rewarding the key employees.

To have the reward or bonus payable to the key employees reflect an increase in the value of the business, the plan will likely contain an incentive formula that is linked to increases in either the income or the cash flow of the business. In its simplest form, an incentive plan gives the key employees a cash bonus if certain criteria are achieved or certain thresholds are exceeded. Moreover, rather than having a 100% payout of the cash bonus immediately after the year of performance, only a part of the bonus should be paid currently and the remainder be subject to vesting, thus providing the proverbial “golden” handcuffs for retaining that key employee.

A fictional example how a business owner might set up a company’s incentive plan is described below.

After meeting with his advisors, Bob, the business owner, decides to give two of his key employees a total of 30% of the company’s pre-tax income above $100,000 (the company’s historic performance level). After Bob installs this plan, and gets the “buy-in” by the two key employees, the company’s pre-tax income increases to $300,000. As a result, the two key employees share 30% of the “excess income” ($200,000) or $60,000.

$300,000	Taxable Income
($100,000)	Historical performance level
$200,000	Excess income
x 30%	
$ 60,000	Total bonus available to be divided among key employees

Because Bob wants to incentivize the two key employees to stay with the company over a long period of time, the plan provides that half of this bonus would be paid currently but the other half would be part of a non-qualified deferred compensation plan with vesting.

$60,000	Amount earned by the key employees
50%	Immediate payout
50%	Deferred compensation

Employee A	Employee B
$15,000 Payout	$15,000 Payout
$15,000 deferred	$15,000 deferred

In summary, Bob’s plan, as most plans should, has the result that as the cash flow of the business increases, and thus the value of the business increases, the key employees are rewarded in a way that reflects this increase in the value of the business. Thus the goals of the key employees and the business owner, being both complementary and synergistic, are both attained concurrently over time.

It is very important to keep in mind that the formula adopted by one business may well be different than the formula adopted by another business. Each plan must reflect the true “value drivers” for each particular business that can be positively impacted by the efforts of those key employees selected by the business owner to participate in the incentive plan.

REQUIRED BEGINNING DATE APPROACHING

Many IRA owners have been able to hold appreciating assets in their IRAs for many years, if not decades. Not only have distributions not been required, but the income realized from the investments in the IRA has not been subject to tax. However, because such accounts are designed to be used for retirement, distributions must begin by what is referred to as an IRA owner’s “required beginning date.” Generally, the required beginning date is April 1st of the year following the year the IRA owner turns 70.5. Once the IRA owner reaches his or her required beginning date, he or she must begin taking distributions, which are referred to as required minimum distributions (“RMDs”). However, no RMDs are required to be taken from a Roth IRA during the owner’s lifetime.

Consequently, if someone turned 70.5 in 2013 and did not take a RMD in 2013, this 2013 RMD will need to be taken by April 1, 2014. If the correct RMD is not taken by the due date, it is considered an excess accumulation and a 50% penalty is assessed to the extent the RMD was not distributed to the IRA owner. IRC 4974 does provide potential relief for the excess accumulation penalty. In order to obtain relief, the IRA owner must establish that the failure to take the full RMD was due to reasonable error and reasonable steps are being taken to remedy the shortfall.

Finally, while April 1, 2014 is the final date for taking the RMD for an IRA owner who turned 70.5 in 2013, the IRA owner must also take the RMD for 2014 by December 31, 2014. Feel free to contact Bradford N. Dewan with any questions regarding the above information.

MILLER, MONSON, PESHEL, POLACEK & HOSHAW
A Partnership of Professional Law Corporations
Providing quality legal services since 1959

RALPH GANO MILLER, RETIRED
THOMAS M. MONSON
MARY J. PESHEL
TIMOTHY C. POLACEK
WILLIAM D. HOSHAW†
SUSAN L. HORNER
BRADFORD N. DEWAN
PHILIP R. FREDRICKSEN†
DeETTE L. LOEFFLER
JUDY S. BAE
†OF COUNSEL

http://www.mmpph.com