

March/April 2012

# Loop HOLES

Family businesses

Now's the time for estate planning

Exploring the ins and outs of NOLs

Tax planning in litigation

How to ensure optimal tax treatment

Tax Tips

Mixing business and pleasure,  
tax breaks for hiring heroes, and more



**CPAs & Business Advisors**

17501 East 17th Street, Suite 100 Tustin, CA 92780-7924  
(714) 505-9000 Fax: (714) 505-9200

## Family businesses

# Now's the time for estate planning

The combination of historically low gift tax rates, historically high exemption amounts and favorable interest rates makes it an ideal time for family business owners to share the wealth. But be sure to start planning soon — there's no guarantee these conditions will last.

Currently, the top gift and estate tax rates are each 35%. There's also a unified gift and estate tax exemption of \$5.12 million (\$10.24 million for married couples). You can transfer up to the exemption amount — through either lifetime gifts or bequests at death — tax-free. Unless Congress passes new legislation, however, in 2013 the exemption will drop to \$1 million (\$2 million for married couples) and the top tax rate will jump to 55%.

### The challenge for business owners

For family business owners, estate planning and succession planning are often at odds with each

other. On the one hand, the sooner you transfer assets to the younger generation, the greater your ability to remove future appreciation from your taxable estate. On the other hand, you may not have identified a likely successor — or, even if you have, you may not be ready to hand over the reins to your business.

---

*A GRAT or a sale to an IDGT can allow you to separate ownership succession from management succession and thus transfer business ownership without giving up control.*

---

Another challenge you'll need to deal with is funding your own retirement. It's not unusual for owners to have most of their wealth tied up in the business. But if you give your business to your kids, there may be little left for your golden years.

Fortunately, several planning vehicles can help you meet these challenges. Two in particular — a grantor retained annuity trust (GRAT) and a sale to an intentionally defective grantor trust (IDGT) — can be highly effective in the current environment. They allow you to separate *ownership* succession from *management*



succession and thus transfer business ownership without giving up control. And they also can help fund your retirement.

### The advantages of a GRAT

Here's how a GRAT works: 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. GRATs offer several important advantages, including:

**Minimal gift taxes.** Gift tax is based on the actuarial value of your beneficiaries' future interest in the trust assets. 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."

**Control.** You remain in control of the business during the trust term.

**An income stream.** The annuity payments provide a source of income to fund your retirement or other needs.

Establishing a GRAT while tax rates are low and the exemption is high will help you minimize or eliminate gift taxes. Keep in mind that for a GRAT to succeed you *must* survive the trust term, and the 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 benefits of selling to an IDGT

An IDGT is an irrevocable trust designed so that contributions to the trust are considered completed gifts for gift tax purposes even though the trust is considered a "grantor trust" for income tax purposes. (That's the "defect.") Selling your business to an IDGT rather than

## More options for transferring a family business

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

**Outright gifts.** If you're willing to relinquish control, you can transfer substantial interests tax-free using the \$5.12 million exemption.

**Installment sales to family members.** These offer significant gift and estate tax savings, provided you're ready to part with the business.

**Self-canceling installment notes.** A SCIN requires 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.

**Family limited partnerships.** FLPs enable you to transfer large interests in the business to family members at discounted gift tax values, while retaining management control.



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, payments you receive from the trust generally will be tax-free.

You can simply give your business to an IDGT, but an installment sale to the trust offers two key advantages:

- ☉ Selling the business avoids gift taxes: Once the note is paid off, the remaining trust assets pass to your beneficiaries tax-free.
- ☉ Regular installment payments provide you with a tax-free income stream.

To help ensure that the IRS won't challenge the sale as a disguised gift, it's important to structure it as a legitimate business transaction. The interest rate, payment schedule and other terms should be commercially reasonable.

You'll also need to contribute some "seed money" to the trust so that it has the resources it needs to make a reasonable down payment (typically, at least 10% of the sale price). The seed money is a taxable gift, but you'll likely be able to avoid the gift tax by using your gift tax exemption.

As with a GRAT, the success of a sale to an IDGT depends in part on the business generating enough income to cover the note payments — something that's easier to achieve in a low-interest environment.

### **The need for a plan**

For family business owners, business and personal planning go hand in hand. To achieve your goals, it's important to develop an integrated family business plan that addresses ownership and management succession issues together with estate planning issues. ☉

## **Exploring the ins and outs of NOLs**

A net operating loss, or NOL, occurs when a business's operating expenses and other deductions for the year exceed its revenues. And, although the name would seem to indicate that operating in a "loss" situation is negative, some benefit actually can come from a year in which you have an NOL: a tax deduction.

### **Understanding the rules**

To qualify for an NOL deduction, you must have business expenses in excess of your business income, though certain modifications apply. Generally speaking, once you incur a qualifying



NOL, you can either carry back the NOL as far as allowable (typically two years) and then carry forward any remaining amount, or you can elect to carry forward the entire loss.

Carrying *back* a loss can generate a current tax refund, which could free up cash flow during difficult times like these. Carrying *forward* a loss will offset income for up to 20 years in the future.

### A review of how it works

To illustrate the NOL concept, let's look at a fictitious example. Having suffered a drastic slowdown in sales, Company X, a C corporation, shows a \$60,000 NOL for the 2011 tax year.

According to the rules, Company X can choose a carryback period for its NOL of two years preceding the loss (first to the earliest year) and then carry forward any remaining amount for up to 20 years after the year in which it incurred the loss. So, Company X could elect to carry back the entire loss first to 2009. If its 2009 net income was \$6,000, it could use \$6,000 of the NOL to offset this income and receive a refund of the tax it previously paid on that income.

---

*To qualify for an NOL deduction, you must have business expenses in excess of your business income.*

---

Then Company X would have \$54,000 of remaining NOL to apply to the 2010 tax year, after which it would have whatever it hadn't used in 2010 to carry forward to 2012 and beyond until it exhausted the entire \$60,000 loss or hit the 20-year mark, whichever occurred first.

### Another scenario

On the other hand, Company X could opt to carry *forward* the full amount of its \$60,000



NOL. In this case, the business could take up to 20 years to use it as long as the NOL was used to offset any net income each succeeding year. This could help reduce Company X's income in years when it might be in a higher tax bracket.

Going back to that \$60,000 NOL, using it to offset income in a 35%-bracket year could save the business \$21,000, while the same loss that offsets income in a 15%-bracket year would save only \$9,000 — a \$12,000 difference.

Thus, if the company reported low income in the previous two years and consequently fell into low tax brackets, it might want to save the NOL for a carryforward to subsequent years — particularly if future projections appear brighter. Company X may also want to opt for a carryforward if its alternative minimum tax (AMT) liability in previous years makes the carryback less beneficial.

### NOLs to the rescue

If your business needs a shot of cash, carrying back an NOL might be just what the doctor ordered. On the other hand, carrying the entire loss forward might be more beneficial for your business's long-term health. To get a better grip on which prescription is right for you, consult your tax advisor. ☺

# Tax planning in litigation

*How to ensure optimal tax treatment*

If you're a party to a lawsuit or other legal proceeding, the taxability or deductibility of damages can have a big impact on the financial outcome. A little tax planning can help ensure the desired tax treatment.

## Nature of the claim

Generally, the tax treatment of damages depends on the nature of the underlying claim. For example, if you file a discrimination suit against your employer and receive a back pay award, those damages are taxable to you (and deductible by your employer). On the other hand, damages for injury to property are usually a combination of *nontaxable* return of capital and capital gain.

In personal injury cases, the tax treatment of damages can be complicated. The Internal Revenue Code specifically excludes from taxable income compensatory damages received “on account of personal physical injuries or physical sickness,” including certain other financial damages suffered as a result.

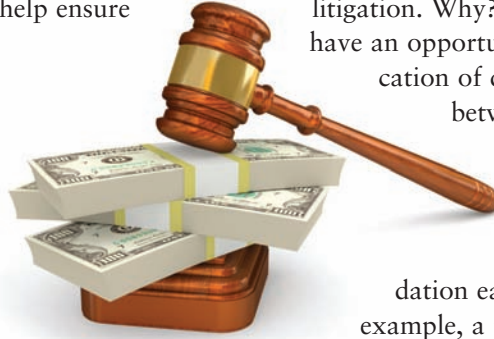
Compensatory damages related to *nonphysical* injuries, however, are taxable. And distinguishing between physical injuries or sickness and nonphysical ones — such as emotional distress — can be a challenge, particularly when nonphysical injuries lead to serious physical problems.

Punitive damages are taxable, as is compensation for lost wages.

## Laying the foundation

Many lawsuits involve both taxable and nontaxable claims — or, from the defendant's

perspective, both deductible and nondeductible claims. To ensure optimal tax treatment, it's important to do some tax planning early in the litigation. Why? Because the parties often have an opportunity to influence the allocation of damages among claims, or between punitive and compensatory damages.



The key to building a case is to lay the foundation early in the litigation. For example, a plaintiff who wants to ensure that the court allocates a significant portion of an award to damages on account of physical injuries or physical sickness should emphasize those claims in the complaint and bring them out at trial.

If parties settle out of court, they must be able to support their allocation of damages in order to survive an IRS challenge. In its recently updated *Lawsuits, Awards, and Settlements Audit Techniques Guide*, the IRS instructs auditors to review settlement agreements closely and challenge an allocation if “the facts and circumstances indicate that the allocation does not reflect the economic substance of the settlement.”

To support an allocation to particular claims, the parties should ensure that those claims are asserted early in the settlement process and that the parties' settlement discussions and correspondence reflect their significance.

## Pay attention to taxes

If you're involved in a legal dispute, taxes may not be your primary concern. But it's a good idea to consult your tax advisor early in the process to discuss opportunities to minimize your tax bill. ©

# tax TIPS

## IRS rethinks position on passive loss rules

For years, the IRS treated owners of limited liability companies (LLCs) and limited liability partnerships (LLPs) as limited partners under the passive activity loss (PAL) rules, regardless of their management participation. This had significant tax implications, because a limited partner's losses are presumed to be passive losses, which can't be deducted from salaries and other "nonpassive" income.

Recently, several court rulings treated LLC and LLP owners as general partners, making it easier for them to deduct losses (provided they satisfy "material participation" standards). In response to those rulings, the IRS is narrowing its definition of a limited partnership for PAL purposes. Under proposed regulations, an interest in an entity would be considered a limited partnership interest only if:

1. The entity was classified as a partnership for federal tax purposes, and
2. The interest holder lacked management rights at all times during the tax year.

This is good news for LLC and LLP owners. It may soon be possible for them to avoid the PAL restrictions if they hold management rights and meet material participation standards. ☺

## Tax breaks for hiring heroes

The recently enacted VOW to Hire Heroes Act enhanced the Work Opportunity tax credit for employers that hire unemployed military veterans through the end of 2012.

The maximum credit is \$5,600 for veterans who have been unemployed for six months or more in the preceding year and \$9,600 for veterans with a service-related disability. Smaller credits may be available in other situations.



You must apply for the credit before you hire someone, so check a prospective employee's eligibility *before* you make a job offer. ☺

## Mixing business and pleasure

Squeezing a few days of rest and recreation into a business trip can be a great way to take a low-cost vacation. But review the rules so you don't inadvertently lose valuable tax deductions.

Generally, the cost of travel to and from a destination (for you, but not for any nonemployee traveling companions) is deductible, provided the primary purpose of your trip is business. Once you're there, carefully document your business vs. personal expenses.

Whether your trip is primarily for business depends in part on the number of days spent on business vs. pleasure, but that's not the only factor. For example, the IRS may treat "standby days" as business days, even if you're doing something else while you wait. And it may be possible to deduct certain expenses on personal days if tacking a few days onto your trip reduces the overall cost. Special rules apply to travel outside the United States. ☺



## ABOUT HMWC:

How do you judge the strength of a professional services firm? At **HMWC CPAs & Business Advisors**, we believe two measures are relevant: the success of our clients and the quality of our people — the professionals who bring their knowledge, skills and experience to the engagement.

For more than 40 years, **HMWC CPAs & Business Advisors** has specialized in serving the financial and tax needs of privately-held businesses and their owners throughout Southern California. The depth and breadth of our experience — which includes such ancillary services as business consulting, business valuation, employee benefits and human resources services, estate planning and computer consulting — make us a valuable member of our clients' management team. At **HMWC CPAs & Business Advisors**, we are more than accountants, ***we are trusted business advisors.***

As a member of Integra International, we have both a national and international presence, which provides us with the resources to consult on a variety of multi-state and global tax and business issues. At the local level, the firm has a highly talented partner and manager group whose involvement on each account helps ensure that our client receives the necessary attention and personal service needed to effectively manage their business. *At **HMWC CPAs & Business Advisors**, our mission is to provide our clients, regardless of size, with a level of service and quality that is unparalleled in the industry.*



**CPAs & Business Advisors**

17501 East 17th Street, Suite 100 Tustin, CA 92780-7924  
(714) 505-9000 Fax: (714) 505-9200