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Designing a tax-wise bonus plan

An annual bonus plan can be a great way to attract, retain and motivate employees. And if the plan is designed carefully, you can deduct bonuses earned this year even if you don't pay them until next year. Sound interesting? Read on.

The 2½ month rule

Many employers assume they can deduct bonuses earned during a tax year so long as they pay them within 2½ months after the end of that year (by March 15 for a calendar-year company). But that's not always the case. For one thing, this tax treatment is available only to *accrual-basis* taxpayers — *cash-basis* taxpayers must deduct bonuses in the year they're paid, regardless of when they're earned. Even for accrual-basis taxpayers, however, this treatment isn't automatic. Bonuses can be deducted in the year they're earned *only* if the employer's bonus liability is fixed by the end of the year.

The all-events test

For accrual-basis taxpayers, the IRS determines when a liability (such as a bonus) has been incurred — and, therefore, is deductible — by applying the "all-events test." Under this test, a liability is deductible when:

1. All events have occurred that establish the taxpayer's liability,
2. The amount of the liability can be determined with reasonable accuracy, and
3. Economic performance has occurred.

Generally, the third requirement isn't an issue; it's satisfied when an employee performs the services required to earn a bonus. But the first two requirements can delay your tax deduction until

the year of payment, depending on how your bonus plan is designed.

For example, many bonus plans require an employee to remain in the company's employ on the payment date as a condition of receiving the bonus. Even if the amount of the bonus is fixed at the end of the tax year, and employees who leave the company before the payment date forfeit their bonuses, the all-events test isn't satisfied until the payment date. As discussed below, however, it's possible to accelerate deductions with a carefully designed bonus pool arrangement.

Everyone into the pool

One solution to the problem described above is to establish a bonus pool. In a 2011 ruling, the IRS said that employers may deduct bonuses in the year they're earned — even if there's a risk of forfeiture — so long as any forfeited bonuses are reallocated among the remaining employees in the pool rather than retained by the employer. Under such a plan, an employer satisfies the all-events test because the *aggregate* bonus amount is fixed at the end of the year, even though amounts allocated to specific employees aren't determined until the payment date.

In reaching this result, the IRS has emphasized that the employer:

1. Defines the terms and conditions under which bonuses are paid,
2. Pays bonuses for services performed during the tax year,
3. Communicates the plan's general terms to employees when they become eligible and when the plan is changed,
4. Determines the minimum aggregate bonus amount either through a formula fixed before year end, or based on a board resolution or other corporate action taken before year end, and
5. Reallocates forfeited bonuses among other eligible employees.

Item 4 above is significant: It indicates that a bonus plan satisfies the all-events test if the minimum aggregate bonus is determined according to a *formula* that's fixed by year end. This allows employers to deduct performance-based bonuses tied to earnings or other financial benchmarks, even if the exact amount isn't determined until after year end, when the company's financial reports are prepared.

To ensure that bonuses are deductible this year, employers shouldn't retain any discretion to modify or cancel bonuses before the payment date or condition bonuses on approval by the board or a compensation committee after the end of the year.

Plan carefully

Designing a bonus plan that allows you to accelerate deductions into *this* year for bonuses paid *next* year can reduce your tax bill and boost your cash flow. To enjoy these benefits, work with your tax advisor to ensure you satisfy the all-events test. ◎

Should you change your accounting method?

Suppose you've been deducting bonuses in the tax year they're earned, but paying them to employees during the first 2½ months of the following tax year. If you fail to satisfy the all-events test during the tax year — because, for example, you retain the discretion to modify or eliminate bonuses at any time up until the payment date — you risk a liability for additional income taxes, penalties and interest in the event of an audit.

If you find yourself in this situation, you have a couple of options: First, you can change the terms of your bonus plan, thus eliminating employer discretion to modify or eliminate bonuses. Or, if you wish to retain that discretion, consider filing Form 3115 to apply for a change in accounting method and deduct bonuses in the year they're paid. By voluntarily changing your accounting method, you may gain several benefits, including audit protection for previous tax years, avoidance of interest and penalties, and the ability to spread out the additional income over a four-year period.

The net investment income tax

Planning opportunities for small business owners

If you own an interest in an S corporation, partnership or LLC, it's a good idea to review the potential impact of the net investment income tax (NIIT). There may be opportunities to reduce or even eliminate the tax.

How the tax works

The NIIT is a 3.8% tax on interest, dividends, annuities, rents, royalties, net capital gains and other investment income earned by high-income individuals (as well as trusts and estates). Several types of income are exempt, including income derived in the ordinary course of a trade or business that's not a passive activity with respect to the taxpayer.

A high-income earner is an individual whose modified adjusted gross income (MAGI) exceeds $200,000 ($250,000 for joint filers, $125,000 for married filing separately). The tax applies to the *lesser* of your net investment income (NII) or the amount by which your MAGI exceeds the applicable threshold.

Planning opportunities

Whether income from a business is subject to the NIIT depends in part on whether you "materially participate" in the business. In some cases, increasing your participation may provide a tax advantage. Also, any income that's considered self-employment income for self-employment tax purposes is *not* considered NII.

IRS regulations set forth several tests for determining material participation. For example, you materially participate if you:

- Participate more than 500 hours per year,
- Participate more than 100 hours per year and as much as or more than any other person, or
- Participate on a "regular, continuous and substantial basis," based on all the facts and circumstances.

If you're a partner in a partnership (including an LLC taxed as a partnership), your distributive share of the partnership's business income, as well as any guaranteed payments for services, is considered self-employment income — and, therefore, exempt from the NIIT — regardless of your level of participation.

Certain types of partnership income aren't considered self-employment income, including passive income (such as interest and dividends) and gain on the sale of a partnership interest. For this type of income, material participation may provide an advantage. If you materially participate: 1) your share of passive income the partnership earns in the course of its trade or business (as opposed to pure investments) is exempt from the NIIT, and 2) only a portion of your gain from the sale of your partnership interest will be considered NII.

Limited partners — including LLC members treated as limited partners — generally avoid self-employment tax (except on guaranteed payments for services). But typically they're subject to the NIIT on their shares of partnership income. With careful planning, LLC members may be able to avoid the NIIT by increasing their participation in the business, but it's difficult — if not impossible — to do so without triggering self-employment tax, which usually results in a heavier tax burden.

What if your business is structured as an S corporation? If you're a shareholder-employee, and you receive reasonable compensation, you're exempt from self-employment tax on your share of the corporation's income. Plus, if you materially participate, you'll also avoid the NIIT on your nonwage income.

Weigh your options

Partners, S corporation shareholders and, possibly, LLC members can avoid both self-employment tax and the NIIT on certain types of income by increasing their participation in the business. Your tax advisor can help you determine whether this strategy is right for you. ◎

Need to protect your assets? Consider a BDIT

A BDIT, also known as the "Beneficiary Defective Inheritor's Trust," is one of the most powerful estate tax and asset protection strategies available to taxpayers. Essentially, it's a third-party settled trust designed to give the taxpayer (who is both a trustee and the initial primary beneficiary of the trust) control and beneficial enjoyment of trust property such that the taxpayer can use and manage the trust assets without compromising the trust's ability to avoid transfer taxes at the client's death, and to protect the trust assets from the client's creditors.

How a BDIT works

Popular estate planning tools such as grantor retained annuity trusts and intentionally defective grantor trusts offer many benefits. They enable you to leverage valuation discounts to reduce gift, estate and generation-skipping transfer taxes. And they allow you to "freeze" asset values at their date-of-contribution levels, protecting all future appreciation from transfer taxes.

These tools also take advantage of the grantor trust rules to generate additional estate planning benefits. The trust's income is taxed to you, as grantor, allowing the assets to grow tax-free and preserving more of your wealth for future generations. Essentially, your tax payments are additional, tax-free gifts to your children or other beneficiaries. And, because a grantor trust is your alter ego, you can sell it appreciated assets — removing them from your estate — with no income tax consequences.

Despite these benefits, most traditional trusts suffer from a significant disadvantage: You must relinquish the right to control, use or direct the ultimate disposition of the trust assets. If you wish to take advantage of trust-based estate planning techniques but you're not ready to let go of your wealth, a BDIT may be the answer.

Why the tool is important

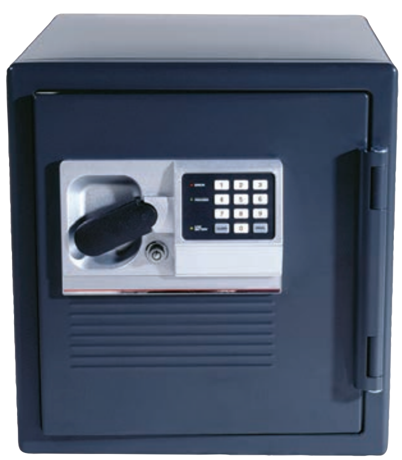
The BDIT's benefits are made possible by one critical principle: Assets transferred by a third party (such as a parent) to a properly structured trust for your benefit enjoy transfer-tax savings and creditor protection, even if you obtain control over those assets.

The trust's income is taxed to you, as grantor, allowing the assets to grow tax-free and preserving more of your wealth for future generations.

IRS rules prohibit you from transferring assets to beneficiaries on a tax-advantaged basis if you retain the right to use or control the assets. But those rules don't apply to assets you *receive* from others in a beneficiary-controlled trust. The challenge in taking advantage of a BDIT is to place assets you currently own into a third-party trust.

An example

The classic BDIT strategy works like this: Let's say Mary owns her home and several other pieces of real estate in an LLC. She'd like to share these properties with her two children on a tax-advantaged basis by transferring LLC interests to trusts for their benefit, but she's not yet ready to relinquish control. Instead, she arranges for her father to establish two BDITs, each naming Mary as primary beneficiary and trustee and one of Mary's children as a contingent beneficiary.



To ensure that the BDITs have the economic substance necessary to avoid an IRS challenge, Mary's father "seeds" the trusts with cash. He also appoints an independent trustee to make decisions that Mary can't make without jeopardizing the strategy, including decisions regarding discretionary distributions and certain tax and insurance matters.

In addition, in order for each trust to be "beneficiary defective," the trust documents grant Mary carefully structured lapsing powers to withdraw funds from the trust. This "defect" ensures that Mary is treated as the grantor of each trust for income tax purposes.

After the BDITs are set up, Mary sells a one-third LLC interest to each trust at fair market value (which reflects minority interest valuation discounts) in exchange for a promissory note with a market interest rate. When the dust settles, Mary has removed the LLC interests from her taxable estate at a minimal tax cost, placed them in trusts for the benefit of herself and her heirs, and provided some creditor protection for the trust assets.

Unlike a traditional trust strategy, however, this strategy allows Mary to retain the right to manage and use the trust assets, to receive trust income and to withdraw trust principal in an amount needed for her "health, education, maintenance or support." In addition, Mary can remove and replace the independent trustee and use a special power of appointment to distribute trust assets as she sees fit (so long as she doesn't direct distributions to herself, her estate or her creditors).

The bottom line

If you're considering creating a BDIT, make sure you work with a qualified estate tax advisor. He or she can help you create the BDIT and ensure it works for your family. ◎

tax TIPS

Thinking about expatriation? Watch out for the "exit tax"

In recent years, a large number of Americans living abroad — or planning to do so — have renounced their U.S. citizenship to avoid U.S. taxes. Expatriation can provide a tax advantage over the long term: U.S. citizens and residents generally pay U.S. taxes on their worldwide income, while expatriates are taxed only on their U.S.-source income.

If you're contemplating this strategy, consider the "exit tax." The tax applies if you've been a U.S. citizen or resident for at least eight of the last 15 years and your average annual net income tax liability for the preceding five years exceeds a certain threshold ($161,000 for 2016), and your net worth is $2 million or more. Last, the tax applies if you fail to certify compliance with your U.S. tax obligations for the preceding five years.

If the tax applies, you'd be treated as if you'd sold all of your assets at fair market value on the day before expatriation. You'd also be taxed on the hypothetical gain to the extent it exceeds a certain threshold ($693,000 for 2016). But if you start planning early, certain strategies can minimize the exit tax, such as gradually liquidating appreciated assets or taking advantage of limited partnerships. ◎

Undo your Roth IRA conversion?

For many people, converting a traditional IRA to a Roth IRA provides long-term tax advantages, but these advantages come at a short-term tax cost: When you convert, you must pay taxes on all of the contributions you previously deducted and on the account's earnings. In addition, a Roth conversion may push you into a higher tax bracket.

If you did a Roth conversion last year, but the value of your IRA has since declined, consider undoing the conversion. Generally, you have until October 15, 2016, to undo a 2015 conversion. Then, so long as you wait at least 30 days, you can redo the conversion at a lower tax cost. Keep in mind that there's a risk that the value of your IRA will rebound during the waiting period, resulting in even higher taxes. ◎

No tax on identity protection services

Organizations that experience data breaches often provide identity protection services, free of charge, to their employees, customers or others whose personal information is at risk. These services may include credit reporting and monitoring, identity theft insurance and identity restoration services.

In a recent announcement, the IRS clarified that individuals whose personal information may have been compromised in a data breach needn't include the value of such identity protection services in their gross income. ◎