Tax Impact

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Tax Tips

Timing compensation in a changing tax climate

All eyes on Sec. 409A

Many people expect to see significant tax reform in the near future now that Republicans are in control of Congress and President Trump is in office. Among the changes being discussed are reduced marginal tax rates for individuals, lower corporate tax rates and the elimination of the surtax on net investment income. It's uncertain, however, when (and if) such changes will be implemented and how long reduced tax rates will last.

Assuming that tax rates are reduced, and that favorable rates won't last forever, what does this mean for compensation programs? Many executives and business owners will want to take advantage of this window of opportunity by deferring or accelerating compensation so that it's received while rates are low. As you consider strategies for timing compensation payments, however, it's critical to be mindful of Internal Revenue Code Section 409A.

Sec. 409A in a nutshell

Sec. 409A is designed to prevent executives, other employees and certain independent contractors from using nonqualified deferred compensation arrangements — including bonus plans, supplemental executive retirement plans and discounted stock options — to defer income taxes while retaining control over the timing of benefits. Violations result in immediate taxation of vested benefits and a 20% excise tax, plus interest.

Certain arrangements are exempt from Sec. 409A, including qualified retirement plans and "bona fide" vacation, sick leave, compensatory time, disability and death benefit plans.

Sec. 409A is complex, but in a nutshell, it restricts an employee's ability to manipulate the timing of income as follows:

1. An election to defer income must be made *before* the year in which the compensation is earned. For example, if you wish to defer a portion of your 2018 compensation to 2019, you must make the election by the end of 2017. There are exceptions for new employees, certain qualifying performance-based compensation and certain bonus plans. (See "Limited exception allows deferral of bonus payments" on page 3.)

2. Deferred compensation must be paid (a) on a specified date or according to a fixed payment schedule, *or* (b) after the occurrence of a specified event, such as death, disability, separation

Limited exception allows deferral of bonus payments

Internal Revenue Code Section 409A generally requires you to make an election to defer compensation in the year before you earn it. This makes it difficult to defer compensation to take advantage of declining tax rates. Suppose, for example, that lawmakers enact a tax cut that takes effect in 2018. To defer a portion of your 2017 income to next year, an election would have been required by the end of 2016.

Sec. 409A contains a limited exception for short-term deferrals that allows a business to defer certain bonus payments to the following tax year. A bonus plan is deemed to comply with Sec. 409A if 1) it provides for bonuses to be paid no later than 2½ months after the end of the tax year (or, if later, the employer's fiscal year) in which bonuses become fully vested, and 2) recipients do not have the power to designate the year of payment.

from service, change in ownership or control of the employer, or an unforeseeable emergency.

3. Once scheduled, payments may be deferred further, provided an election is made at least 12 months in advance and the new payment date is at least five years after the originally scheduled date.

Generally, once an election is made to defer compensation, payments can't be accelerated except, as discussed below, in limited circumstances.

Accelerating compensation

Sec. 409A generally prohibits companies from paying deferred compensation earlier than scheduled. This prohibition makes it difficult to accelerate payments to take advantage of tax cuts. There are, however, 13 limited exceptions to the antiacceleration rule. Most of the exceptions involve extraordinary circumstances, such as payments needed to comply with a domestic relations order, pay employment taxes or meet certain other obligations. However, one exception — for plan termination — may create tax-planning opportunities for some businesses.

Under this exception, an employer may accelerate deferred compensation payments without violating Sec. 409A, provided the payments are made in connection with termination and liquidation of the plan and:

- The plan isn't terminated because of a downturn in the employer's financial condition,
- All similar nonqualified deferred compensation plans are also terminated,
- No payments are made within 12 months after termination,
- All payments are completed within 24 months after termination, and
- The employer doesn't adopt any similar plans within 36 months after the termination was initiated.

Terminating a plan is one option for taking advantage of lower tax rates. But before choosing this strategy, it's important to consider its impact on your company's compensation programs.

Plan carefully

Accelerating and deferring income is a tried-and-true strategy for making the most of fluctuating tax rates. But when nonqualified deferred compensation plans are involved, it's important to plan carefully to avoid running afoul of Sec. 409A. ■

How to get relief from IRS penalties

Too often, taxpayers hit with penalties by the IRS simply accept them, write a check and move on. But in certain cases, it's possible to get these penalties abated. That won't happen, though, unless you ask.

Types of penalties

Generally, IRS penalties fall into one of three categories:

1. Failure-to-file and failure-to-pay penalties,
2. Estimated tax penalties, and
3. Accuracy-related penalties.

Abatement relief varies depending on the type of penalty. Here are some general guidelines for seeking relief:

Failure-to-file and failure-to-pay penalties. First, make sure that the information in the notice you received is correct. If it is, determine whether you're entitled to penalty abatement for reasonable cause. According to the IRS, it'll consider any reason that establishes that you were unable to meet your federal tax obligations despite using "all ordinary business care and prudence" to do so.

The most common reasons are:

- Fire, casualty, natural disaster or other disturbances,
- Inability to obtain records, and
- Death, serious illness, incapacitation or unavoidable absence of the taxpayer or an immediate family member.

Abatement relief varies depending on the type of penalty.

Other possible reasons include reliance on written or oral advice from the IRS, a math error or other mistake by the IRS, and undue hardship.

If you don't have a good reason for filing or paying late, you may be able to apply for a first-time penalty abatement (FTA) waiver. To qualify for relief, you must satisfy three requirements: 1) You received no penalties (other than estimated tax penalties) for the three tax years preceding the tax year in which you received a penalty, 2) you're current on all required returns or filed a valid extension of time to file, and 3) you've paid, or arranged to pay, any tax due. Be aware that, despite the expression "first-time," you can receive FTA relief more than once, so long as at least three years have elapsed.

Regardless of whether you're applying for reasonable cause or FTA relief, keep

in mind that failure-to-pay penalties continue to accrue until they're paid in full. So it's a good idea to wait until you've paid the taxes due before requesting penalty relief.

Estimated tax penalties. Although it's possible to obtain relief from estimated tax penalties on grounds of casualty, disaster or other unusual circumstances, such relief is rarely granted. You're more likely to get these penalties abated if you can prove that the IRS made an error, such as crediting a payment to the wrong tax period, or that calculating the penalty using a different method (such as the annualized income installment method) would reduce or eliminate the penalty.

Accuracy-related penalties. These penalties may be imposed, for example, if the IRS finds that your return was prepared negligently or that there's a substantial understatement of tax. You can obtain relief from these penalties if you can demonstrate that you properly disclosed your tax position in your return and that you had a reasonable basis for taking that position.

Generally, you have a reasonable basis if your chances of withstanding an IRS challenge are greater than 50%. Reliance on a competent tax advisor greatly improves your odds of obtaining penalty relief.

Other possible grounds for relief include computational errors and reliance on an inaccurate W-2, 1099 or other information statement.

Get help

If you believe that you're entitled to relief from tax penalties, talk to your tax advisor. He or she can help you determine the appropriate grounds for relief, prepare any documentation necessary to support your claim and file an application with the IRS. ■

Are you a member of the Sandwich Generation?

If you're currently taking care of your children *and* your elderly parents, count yourself among those of the Sandwich Generation. Although it may be personally gratifying to be able to help your parents, it can be a financial burden.

How can you best handle the financial affairs of parents in the later stages of life? Incorporate their needs into your own estate plan while tweaking, when necessary, the arrangements they've already made. Here are five critical steps:

Identify key contacts. Just like you've done for yourself, compile the names and addresses of professionals important to your parents' finances and medical conditions. These may include stockbrokers, financial advisors, attorneys, CPAs, insurance agents and physicians.

List and value their assets. If you're going to be able to manage the financial affairs of your parents, having knowledge of their assets is vital. It would be wise to keep a list of their investment holdings, IRA and retirement plan accounts, and life insurance policies, including current balances and account numbers. Be sure to add in projections for Social Security benefits. When all is said and done, don't be surprised if their net worth is

higher or lower than what you (or they) initially thought. You can use this information to formulate the appropriate planning techniques.

Open the lines of communication. Before going any further, have a frank and honest discussion with your elderly relatives, as well as other family members who may be involved, such as your siblings. Make sure you understand your parents' wishes and explain the objectives you hope to accomplish. Understandably, they may be hesitant or too proud to accept your help initially.

> ***If you're going to be able to manage the financial affairs of your parents, having knowledge of their assets is vital.***

Execute documents. Assuming you can agree on how to move forward, develop a plan incorporating several legal documents. If your parents have already created one or more of these documents, they may need to be revised or coordinated with new ones. Some elements commonly included in an estate plan are:

- *Wills.* Your parents' wills control the disposition of their possessions, such as cars and jewelry, and tie up other loose ends. (Of course, jointly owned property with rights of survivorship automatically passes to the survivor.) Notably, a will also establishes the executor of your parents' estates. If you're the one lending financial assistance, you're probably the optimal choice.

- *Living trusts.* A living trust can supplement a will by providing for the disposition of selected assets. Unlike a will, a living trust doesn't have to go through probate, so this might save time and money, while avoiding public disclosure.

- *Powers of attorney.* These documents authorize someone to legally act on behalf of another person. With a durable power of attorney, the most common version, the authorization continues after the person is disabled. This enables you to better handle your parents' affairs.

- *Living wills or advance medical directives.* These documents provide guidance for end-of-life decisions. Make sure that your parents' physicians have copies so they can act according to their wishes.

- *Beneficiary designations.* Undoubtedly, your parents have filled out beneficiary designations for retirement plans, IRAs and life insurance policies. These designations supersede references in a will, so it's important to keep them up to date.

Spread the wealth. If you decide the best approach for helping out your parents is to give them monetary gifts, it's relatively easy to avoid gift tax liability. Under the annual gift tax exclusion, you can give each recipient up to $14,000 without paying any gift tax. Plus, payments to medical providers aren't considered gifts, so you may make such payments on your parents' behalf without using any of your annual exclusion or lifetime exemption amount.

As you grow older, so do your responsibilities. If you're part of the Sandwich Generation, those responsibilities can include raising your children while also taking care of your aging parents. To help ease the financial burden, discuss all of your options with your financial advisor. ■

Standard mileage rates can lead to inaccurate reimbursements

Many companies use the IRS's standard mileage rate to reimburse employees for business use of their vehicles on a tax-free basis. The rate — 53.5 cents per mile in 2017 — is calculated annually based on blended and weighted cost factors for different types of vehicles nationwide. The standard rate offers the advantage of simplicity, but because of the way it's calculated, it tends to underreimburse low-mileage drivers or those who live in high-cost areas and over-reimburse high-mileage drivers or those who work in low-cost areas.

If your company employs a significant number of employees who drive regularly for business-related reasons, consider using a more accurate reimbursement method, such as a fixed and variable rate plan or tracking actual vehicle expenses. ■

Fixing a broken trust

In a taxpayer-friendly private letter ruling (PLR), the IRS allowed a retroactive modification of several trusts to achieve the donor's tax objectives. The donor's intent was to establish irrevocable grantor retained annuity trusts (GRATs), but the trust agreements omitted certain language required by IRS regulations and, therefore, failed to qualify for favorable gift tax treatment.

A court granted the donor's request to retroactively modify the trusts, as permitted by a Uniform Trust Code provision adopted in the donor's state. The IRS accepted the court's modification of the trusts for tax purposes, emphasizing language in the trust documents expressly stating the donor's intent to establish tax-qualified GRATs.

The PLR is good news for donors who wish to correct the terms of a trust in accordance with state law. It also illustrates the advantages of including statements of intent in trust documents. ■

Is bartering taxable?

It's not unusual for small businesses — especially start-ups that are short on capital — to exchange goods or services instead of cash. For example, a small brewery might ask the graphic designer across the street to design its logo in exchange for several cases of beer. Contrary to popular belief, these bartering transactions are taxable. In this case, the graphic design company would be required to include the fair market value of the beer in its gross income.

Although this sort of informal transaction may fly under the IRS's radar, businesses involved in bartering may be required to file Form 1099-MISC. The penalties for failure to file can be harsh. Also, if you use a barter exchange to broker trades with other businesses, the exchange is required to report the proceeds on Form 1099-B. ■

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