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# TAX & TRANSACTIONS BULLETIN

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- On July 1, 2004, IRS issued favorable Revenue Ruling 2004-64 on "Grantor Trusts"
- This new Ruling allows Families to reduce their overall Tax Liability
- Mom or Dad can fund the "Grantor Trust" and pay its income taxes
- The assets of a "Grantor Trust" then compound tax-free for the Children's benefit
- Careful planning may reduce the Family's effective income tax rate

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## IRS RULING ON "GRANTOR TRUSTS" REPRESENTS A VICTORY FOR TAXPAYERS

On July 1, 2004, IRS issued favorable Revenue Ruling 2004-64 on "Grantor Trusts." A Grantor Trust is any trust whose income is taxed directly to the person funding the trust.[1] The new Ruling creates greater certainty in the tax laws,encouraging tax planning.

In Revenue Ruling 2004-64, Dad establishes an Irrevocable[2] Grantor Trust for his Children. At year-end Dad includes Trust income in his personal income. Dad then pays the tax on Trust income. Since Dad personally paid the tax, Trust has more money available for Children. The Trust cannot reimburse Dad for his payment.

Based on these facts, IRS held that: (1) Dad's payment is not a taxable gift to the Children, and (2) Trust is generally not included in Dad's Estate for estate tax purposes. This Ruling allows Families to reduce their overall tax liability. By setting up an Irrevocable Grantor Trust, Dad ensures certain assets are not subject to his estate tax. And by paying Trust income taxes each year, Dad reduces his Estate and provides more money for his children gift tax-free. Since Dad pays Trust income taxes each year, Trust principal compounds tax-free. The Children ultimately benefit.

Grantor Trusts are flexible. For instance, Dad can decide at the outset whether he wants to pay Trust income taxes each year.[3] Also, Dad can likely establish a Grantor Trust initially, and later decide he no longer wants to pay Trust income taxes. Dad may then "renounce" Grantor Trust status, and for all subsequent years the Trust will pay its own taxes.[4] This safety feature protects Dad from unexpectedly large tax bills in the future.

The following Example illustrates the benefits of Revenue Ruling 2004-64:

*Dad establishes a Grantor Trust for his Children and Grandchildren. Dad initially funds the Trust with $1,000,000. At the end of Year 1, Trust has $60,000 of taxable income. Dad personally pays the $24,000 income tax liability. There are at least four (4) major tax advantages to Dad's strategy. First, Dad's payment reduces*

[1]With a non-Grantor Trust, the income is taxed to the trust itself, and the trustee pays the tax.

[2]Although many individuals establish Revocable Trusts for estate planning purposes, Irrevocable Trusts are an additional tool which can reduce Income and Estate Taxes.

[3]In the event Dad does not want to pay Trust income taxes, he can establish a non-Grantor Trust.

[4]Although practitioners generally agree on the ability to "renounce," no official Ruling endorses this strategy.

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## IRS RULING ON "GRANTOR TRUSTS" REPRESENTS A VICTORY FOR TAXPAYERS (cont'd)

*his estate, saving Dad an extra $12,000 in estate tax.*[5] *Second, Trust saves $24,000 of income tax, and Trust principal compounds Tax-Free. As this program continues, the annual compounding may create substantial wealth for the Family. Third, Trust principal remains outside Dad's estate tax. Fourth, in the event Dad later decides he no longer wants to pay Trust income taxes, Dad can "renounce" Grantor Trust status and "switch" tax liability to the Trust.*

Revenue Ruling 2004-64 is a victory for taxpayers. By providing certainty in this area, IRS allows Families to implement tax planning which benefits their Children and Grandchildren. Grantor Trusts will remain an important part of Income and Estate Tax Planning.

[5]Assumes (i) 6% rate of return, (ii) 40% combined federal & state income tax rate, and (iii) 50% combined federal & state estate tax rate. Note that Dad's $12,000 estate tax savings effectively reduces the income tax rate on Trust income by 50%.

## NONQUALIFIED DEFERRED COMPENSATION PLANNING

Retirement planning is an important economic goal. Many individuals defer salary through Qualified Plans such as pensions and 401(k)/IRA's to provide a cash stream after retirement. However, for an executive to maintain her standard of living after retirement, she generally requires an annual cash flow equal to two-thirds of her final year's salary. Qualified Plan payments and Social Security benefits rarely provide this support.

Executives often establish a Nonqualified Deferred Compensation Plan to cover the shortfall. Nonqualified Plans provide additional retirement income over and above pensions and 401(k)/IRA's, thus providing extra cash flow after retirement.

Nonqualified Plans can be divided into two (2) broad categories: "Funded" plans, and "Unfunded" plans.

In a Funded plan the employer transfers cash or property to an irrevocable trust or escrow account which is beyond the reach of its general creditors. Funded plan assets are protected from the employer's creditors, in the event the employer becomes bankrupt or otherwise insolvent. The Funded plan provides financial security to the executive by transferring her deferred salary to an account for her sole benefit. Unfortunately, the Funded plan triggers immediate income taxation to the executive unless it is subject to a substantial risk of forfeiture[1] and nontransferable.[2] Funded Nonqualified plans are uncommon.[3]

[1]Deferred compensation is subject to a substantial risk of forfeiture if the executive's right to receive the compensation is "conditioned upon the future performance of substantial services." Code Section 83(c)(1); Code Section 457(f)(3)(B) (same definition in both Code Sections). Upon the date that the executive's rights to the compensation are no longer contingent upon providing employment services, the executive has a non forfeitable right and is considered "vested."

[2]Code Section 83.

[3]Nonqualified plans established by State and Local Governments are Funded. See Code Section 457(g). [Note that almost all Qualified plans are Funded.]

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## NONQUALIFIED DEFERRED COMPENSATION PLANNING (cont'd)

In an Unfunded plan the employer does not transfer cash beyond the reach of its own general creditors. Rather, the employer merely makes an unsecured promise to pay money to the executive in the future. The employer may simply credit the deferred salary to a mere bookkeeping account. Alternatively, the employer may set aside the deferred salary in a segregated cash account. In both cases the deferred salary remains subject to the employer's general creditors. The executive has only the rights of an unsecured general creditor. If an employer establishes an Unfunded plan and later becomes bankrupt or insolvent, the executive may receive pennies on the dollar or nothing from the plan. However, the primary advantage of an Unfunded plan is income tax deferral: the executive is not taxed until she receives cash payments from the plan. Unfunded Nonqualified plans are quite popular.[4]

An Unfunded plan is subject to various risks, entailing that the executive may never receive her money from an Unfunded plan. First, the employer may have a "change of mind" after the executive retires and simply decide not to pay. Second, the employer may undergo a "change of control," and new management may decide not to pay. Third, the employer may experience "cash flow difficulties" and use plan monies to pay unrelated business debts. In all three situations, the executive may sue to enforce the plan. Litigation fees and delays, however, will impede the executive. Fourth, the employer may become insolvent. If the employer enters bankruptcy, the executive – as an unsecured creditor – may receive nothing from the plan.

To protect herself from the first three (3) risks of an Unfunded Plan, the executive may ask the employer to establish a Rabbi Trust.[5] Under this arrangement, plan monies are held in an irrevocable trust administered by an independent third-party corporate trustee. The corporate trustee pays out money to the executive according to a written schedule. The irrevocable trust generally does not terminate until all plan participants (and their beneficiaries) are paid. By transferring plan monies to an independent trustee, the Rabbi Trust protects the executive from most risks of an Unfunded plan.[6] However, the Rabbi Trust fails to protect the executive from the bankruptcy risk. If the employer enters bankruptcy or otherwise becomes insolvent, the executive may get nothing from the plan.[7]

Taxable Corporations[8] may establish Unfunded Nonqualified plans. The corporation remains subject to income taxation of plan investments. The corporation also does not receive a salary deduction until plan monies are paid out to the executive.[9] These tax rules create a natural limit on the amount a Taxable Corporation will contribute to a Nonqualified plan. A Taxable Corporation may establish a Rabbi Trust.

[4]An Unfunded Nonqualified plan may payout cash in a lump sum, in a fixed number of installments, or over the life of the executive. The executive is only taxed as the cash is paid. Regulation 1.451-2.

[5]The IRS has issued a model grantor rabbi trust pursuant to Revenue Procedure 92-64. The phrase "Rabbi Trust" originated with a Congregation which set up a retirement plan for the benefit of its Rabbi (see PLR 8113107).

[6]For instance, the Rabbi Trust Agreement may provide that upon a change of control of the employer, the Trustee cannot be removed for three (3) years. This ensures that new management cannot revoke the Trust or acquire control of the Trustee.

[7]Pursuant to IRS Revenue Procedure 92-64, at all times the principal and income of a Rabbi Trust shall be subject to claims of general creditors of the employer under federal and state law.

[8]The term "Taxable Corporation" refers to a for-profit entity which is not exempt from income tax.

[9]The executive reports income at this time.

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## NONQUALIFIED DEFERRED COMPENSATION PLANNING (cont'd)

Tax-Exempt Organizations, including charities and nonprofit corporations, may also establish Nonqualified plans.[10] For many Tax-Exempt Organizations, an Ineligible Plan[11] is the plan of choice. Under an Ineligible Plan – also known as a "Section 457(f) Plan" – the executive may contribute a substantial amount each year. In fact, the deferred amount is often expressed as a percentage (e.g. 25%) of total salary. Since the employer is a tax-exempt charity or nonprofit organization, the employer pays no income tax on Plan earnings. Therefore, deferred amounts grow tax-free, meaning that the executive enjoys a higher rate of return.[12] A Tax-Exempt Organization also may establish a Rabbi Trust.

Nonqualified Plans provide valuable retirement benefits for employees of both Taxable Corporations and Tax-Exempt Organizations. Since both Taxable Corporations and Tax-Exempt Organizations may use a Rabbi Trust, the executive's money can be protected against all major risks except bankruptcy of the employer. Nonqualified Plans will remain popular to Employers as a means of attracting and retaining qualified personnel, and to Executives as a source of retirement income.

[10]In establishing a Nonqualified Plan, a tax-exempt organization can choose between setting up an "Eligible Plan" and an "Ineligible Plan." Both types of Plans are governed by Code Section 457. However, an Eligible Plan is subject to numerous restrictions, most notably a limit on the maximum amount each executive can defer. For 2004, an employee can contribute no more than $13,000 annually to an Eligible Plan.

[11]Ineligible Plans are also known as "Section 457(f) Plans." See IRS Private Letter Ruling 9508014.

[12]An Ineligible Plan exacts a price for permitting the executive to benefit from tax-free asset growth. This price is that the executive initially must be non-vested in the Plan. Provided she remains employed with the organization, the executive vests in her deferred salary at a specified future date. This "vesting date" must be at least 2 years after the executive first participates in the Plan. During the pre-vesting period, the executive risks forfeiting her deferred salary if she voluntarily resigns or is terminated for cause. The executive will not forfeit her deferred salary during the pre-vesting period if her employment ceases due to death, disability, attainment of retirement age, or involuntary termination other than for cause.

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