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TAX & TRANSACTIONS BULLETIN

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- New IRS Revenue Ruling 2005-36 provides valuable tax-planning strategies for the beneficiary of an IRA.
- The new Ruling permits a beneficiary to make a Qualified Disclaimer of the IRA up to 9 months after the Account owner's death.
- The Disclaimer is valid even though the beneficiary already received a partial distribution from the IRA.
- The new Ruling ensures surviving Family members have sufficient time to make decisions and file tax elections for the Estate.

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NEW RULING PROVIDES IRA BENEFICIARIES WITH POST-MORTEM TAX PLANNING STRATEGIES

A new IRS Ruling[1] provides valuable tax-planning strategies for the beneficiary of an Individual Retirement Account ("IRA"). The new Ruling permits a beneficiary to make a Qualified Disclaimer[2] of an IRA up to nine (9) months after the Account owner's death. The Disclaimer is valid even though the beneficiary already received a partial distribution[3] from the IRA.[4]

The new Ruling ensures surviving Family members have sufficient time to make decisions and file tax elections for the Estate. After a death in the Family, the surviving Family members initially may be disorganized. Tax planning for the Estate may not begin for several months. The new Ruling preserves the right of surviving Family members to make decisions and file elections which reduce tax, even where those decisions and elections are delayed for several months after death.

The Ruling confirms that a beneficiary may receive a partial distribution from an IRA and subsequently make a Qualified Disclaimer of the balance of the IRA.[5] A beneficiary may receive a portion of an IRA and then disclaim the balance. The Ruling thus permits a tax-advantaged disclaimer of an IRA, even where the beneficiary previously received an IRA distribution.

Example: Child's Qualified Disclaimer of Inherited IRA Reduces Estate Tax. Dad is age 75 and owns a $1 Million IRA. Each year Dad receives his required minimum distribution from the IRA. Dad designates Son as primary beneficiary of his

[1] Revenue Ruling 2005-36 (June 23, 2005).

[2] Code Section 2518.

[3] Where a beneficiary makes a Qualified Disclaimer of a portion of an IRA, the following two rules apply: (1) disclaimer of a portion of IRA principal requires disclaimer of the pro-rata income attributable to that principal; and (2) acceptance of a portion of IRA principal constitutes acceptance of the pro-rata income attributable to that principal. [See Revenue Ruling 2005-36; Regulation 25.2518-3(c).]

[4] An IRA must make payouts due to the "required minimum distribution rules." These rules require that payouts begin on the owner's "first distribution calendar year," which is the year the owner attains age $70^1/_2$. These payouts must continue to be made each year during the owner's lifetime. After the IRA owner's death, required distributions generally must continue to be made annually to the beneficiary. A beneficiary may inadvertently receive an IRA distribution soon after the owner's death, without realizing that receipt of the distribution could affect the beneficiary's ability to Disclaim the IRA and substantially reduce taxes. New Revenue Ruling 2005-36 confirms that the beneficiary remains eligible to file the Disclaimer after receiving the IRA distribution.

[5] In order to be Qualified, the disclaimer must comply with all requirements of Code Section 2518.

NEW RULING PROVIDES IRA BENEFICIARIES WITH POST-MORTEM TAX PLANNING STRATEGIES (cont.)

IRA. Mom is contingent beneficiary. Dad dies in September 2005. In December 2005 the IRA custodian makes the annual required minimum distribution by paying $40,000 to Son.

In February 2006 Mom and Son meet with their accountant. Mom and Son learn that Dad's estate *potentially* owes $500,000 Estate Tax on the IRA. Son decides to make a Qualified Disclaimer of the entire remaining IRA. The Disclaimer is valid even though Son already received a $40,000 distribution from IRA. Immediately after Son files his Disclaimer, the entire balance of IRA is distributed to Mom. Distribution of the IRA to Mom qualifies for the estate tax marital deduction. The Disclaimer eliminates $500,000 Estate Tax. The Family enjoys a $500,000 savings.

PROPERLY STRUCTURED BUY-SELL AGREEMENT CAN MINIMIZE INCOME AND ESTATE TAXES

Business owners often enter into a Buy-Sell Agreement ("Buy-Sell") with each other. The Buy-Sell typically provides that if an owner dies or leaves the business, the remaining owners may purchase her equity. A Buy-Sell Agreement accomplishes several important goals. First, upon the death or departure of an owner, the Buy-Sell ensures the surviving owners retain control of the business. Second, the Buy-Sell is often funded with life insurance to create a cash payout for the family of a deceased owner. Third, the Buy-Sell may assist in setting a ceiling on the value of the business for Estate Tax purposes.

A Buy-Sell Arrangement is often structured as a Cross Purchase (rather than as a Redemption). In a Cross Purchase the surviving owners purchase the equity interests from the deceased owner's estate. The Cross Purchase allows the surviving owners to take a Stepped-Up Tax Basis in their purchased shares. The Cross Purchase also is more flexible in avoiding estate tax on the life insurance proceeds.[1]

To obtain the best possible economic and tax result, careful planning is essential to a proper Buy-Sell Agreement. One technique which appears to work quite well is a Cross Purchase using a limited liability company (LLC). In Private Letter Ruling (PLR) 9309021, the IRS approved a Cross-Purchase Arrangement using an LLC. Although the LLC had no business activities other than holding the insurance, the Arrangement was exempt from the "Transfer for Value" rules. In PLR 9309021, the LLC owned the insurance policies and administered the Buyout. This arrangement avoids the "Transfer for Value" rules, and permits the surviving owners to obtain a Stepped-Up Tax Basis in their purchased shares. The arrangement also reduces administrative costs since only one (1) policy is needed for each owner, and the LLC allows the owners to have equal co-control and co-management over the policies. The owners make capital contributions to

[1] In a Redemption Agreement the business entity makes the buyout. A Redemption has distinct disadvantages including: (a) the surviving owners fail to receive a Stepped-Up Tax Basis in the redeemed equity; (b) the Redemption structure may trigger the "Transfer for Value" rules, resulting in income taxation of the life insurance proceeds; (c) life insurance proceeds owned by the business entity may be subject to Estate Tax at the owners' death due to attribution; (d) C Corporations are subject to an additional Alternative Minimum Tax on their receipt of life insurance proceeds; (e) the Redemption distribution may impair the entity's capital pool, especially if the insurance proceeds only represent a down payment on the buyout; and (f) a Redemption can be recast by the IRS and taxed as a dividend at ordinary income rates instead of favorable capital gains (although the new 15% tax on qualifying dividends paid thru December 31, 2008 may ameliorate this last risk).

PROPERLY STRUCTURED BUY-SELL AGREEMENT CAN MINIMIZE INCOME AND ESTATE TAXES (cont.)

the LLC which then pays all premiums on the policies. Upon the death of an owner, the cash insurance proceeds are collected by the LLC. The LLC then distributes the cash proceeds to the surviving owners, who are required to use that cash to purchase the equity interests in the business from the Estate of the deceased owner at an agreed purchase price. The end result is that the deceased owner's Family receives a cash payout, and the surviving owners control and own all shares in the business.

Where a Cross Purchase uses an LLC to own the insurance policies, a major Estate Tax issue arises since each LLC owner may possess effective control over her own life insurance policy.[2] There is a possible solution to this Estate Tax issue. The LLC operating agreement may stipulate that each LLC owner is prohibited from exercising ownership rights or making decisions with respect to any policy insuring that owner's life.[3] The LLC operating agreement might even establish a separate third-party "Insurance Manager" who makes all decisions on the life insurance policies. These additional safeguards may prevent the life insurance from being included in an LLC owner's taxable Estate.

[2] Code Section 2042 provides that a decedent's taxable Estate includes the proceeds of all life insurance policies on the decedent's life, to the extent the decedent possessed at death (or within 3 years of death) any "incidents of ownership" on a policy.

[3] See Private Letter Ruling 200017051, in which the IRS ruled that the General Partners of a family limited partnership did not possess incidents of ownership on life insurance policies insuring their lives which were owned by the Partnership. The partnership agreement contained a clause which prohibited any partner from exercising any incident of ownership with respect to a partnership-owned policy insuring that partner's life.

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