convert to an S corporation

Yet another approach is to convert your company to an S corporation, which allows partnership-like taxation. Then issue new S corporation shares to your children as a stock bonus in addition to their salaries.

Advantage: Excess compensation is not an issue with an S corporation because double taxation (corporate plus personal income taxes) doesn't apply.

Pitfall: Conversion from a C corporation to an S corporation requires valuation of the built-in gains. There is a 10-year holding period to avoid double taxation if the assets of the company are sold in that time frame. Careful planning is required.

Strategy: Your children can receive cash if the S corporation distributes its profits to stockholders. This cash can be used to buy your shares from you.

If the purchase is made on an installment basis, the children can obtain your shares immediately while making payments over several years.

Result: You'll relinquish control while pocketing cash, paying tax at favorable long-term capital gains rates. **TH**

CALAMITY Hotline

Tax Help for Hurricane Victims

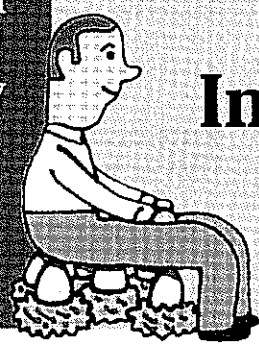
A new on-line tool helps hurricane victims claim the earned income and additional child tax credits. New rules help victims of Hurricanes Katrina, Rita, and Wilma by letting them claim these tax credits using either their 2004 or 2005 incomes, whichever is most advantageous. But many victims of these storms have lost their 2004 tax records.

Help: The new tool provides the needed 2004 information to them through the IRS Web site. Go to *www.irs.gov*, click on "Help for Hurricane Victims," and then on "Your 2004 Earned Income Option." Taxpayers without Web access can seek the information via automated telephone line by calling 866-562-5227.

IRS News Release IR-2006-21.

ASSET PROTECTION HOTLINE

A Brand New Strategy to Protect Your Family



The IRA Inheritance Trust

Philip J. Kavesh, Esq.
Kavesh, Minor & Otis, Inc.

If an IRA is left directly to heirs, they might strip the account quickly, and the benefit of long-term tax deferral will be lost. Money in an IRA inherited outright might be subject to creditors and divorce proceedings—and any money withdrawn from that IRA certainly will be exposed.

Leaving your IRA to a trust offers several advantages. As is the case with any assets held in trust, an inherited IRA will be better protected from creditors and from reckless spending. Using a trust, then, provides greater assurance that long-term tax deferral will be realized.

Moreover, leaving the IRA to a trust with a reliable trustee can ensure that only minimum required distributions (MRDs) are taken, as long as there's no pressing need for cash. Doing this will provide your heirs with extended tax deferral and the chance for superior wealth building.

Bad deal for heirs? Perhaps, for those who want to spend even more of the money. But an heir who does this to excess might not think a trust would have been such a bad deal after the money is gone. A trustee can be given the power to tap the IRA, if necessary, but also the ability to pay out as little as possible, so a $500,000 inheritance can wind up paying $2 million, $3 million, or more to the heirs over time.

trust troubles

There are disadvantages to leaving an IRA to a trust, though. The IRS interprets the MRD rules strictly for trust beneficiaries, which can lead to curtailed tax deferral.

Example: You leave your IRA to a trust, naming your brother Saul as the trustee. Saul will have the discretion as to how much he distributes to your daughter Jan, who is the primary trust beneficiary.

This serves to protect the assets. Saul can take minimum distributions from the IRA and hold the money in trust, if he wants to keep Jan from spending too freely or losing the money to creditors or divorce.

Trap: The IRS views the above arrangement as an "accumulation trust." With such trusts, the shortest life expectancy of all the possible trust beneficiaries will be used to determine MRDs.

Suppose that the IRA passes to the trust when Jan is 47, with a 37-year life expectancy on the IRS table. If her Aunt May, 70 years old with a 17-year life expectancy, is the oldest of the secondary beneficiaries, money must be withdrawn from the IRA on a 17-year schedule.

Result: Taking money from the IRA over 17 rather than 37 years will abbreviate tax deferral and reduce potential wealth building. However, if Jan's siblings or her children are the secondary beneficiaries, her tax de-

Tax Hotline interviewed Philip J. Kavesh, Esq., principal, Kavesh, Minor & Otis, Inc., 990 W. 190 St., Torrance, California 90502. His law firm created the IRA Inheritance Trust and successfully obtained a Private Letter Ruling from the IRS.

ferral may not be significantly, or at all, affected.

Alternative: In order to ensure long-term tax deferral, a "conduit" trust (rather than an accumulation trust) may be desirable in certain cases.

How it works: A conduit trust has a single individual as a primary beneficiary. The trustee is required to take at least the MRD amount from an inherited IRA each year, and pass that amount through to the trust beneficiary.

Advantage: With a conduit trust, the primary beneficiary's life expectancy can be used to stretch out MRDs.

Disadvantage: Distributions can't be accumulated in the trust. They'll definitely be passed through to the trust beneficiary, who may spend the money or lose it to creditors. However, the IRA principal may still be protected.

Bottom line: Up to now, leaving an IRA to a trust has meant choosing between (a) the maximum protection of an accumulation trust or (b) the maximum tax deferral of a conduit trust.

introducing the IRA Inheritance Trust

Last year, at the request of my firm, the IRS issued Private Letter Ruling 200537044, approving an "IRA Inheritance Trust." A Private Letter Ruling is an IRS document that approves or rejects a specific request, such as the use of a trust designed in a certain way, for a particular taxpayer.

In essence, with this new strategy, a benefactor begins by creating either an accumulation or conduit trust that will inherit his/her IRA. After death, an independent party can "toggle" (see below) from one of these types of trust to the other, depending on the beneficiary's needs.

First steps: This strategy calls for creation of a revocable trust to inherit the IRA.

Vital: This trust should be a one-purpose trust. If you also have a revocable trust to hold other assets during your lifetime, a separate revocable trust should be set up to inherit your IRA.

At your death, this IRA Inheritance Trust will divide into smaller trusts, one for each intended beneficiary.

Example: You intend to divide your IRA among your three children. At your death, the IRA Inheritance Trust (which becomes irrevocable at your death) will divide into one trust for your son Adam, one for your daughter Beth, and one for your daughter Carol.

switch play

Of course, the ideal situation is one in which you already have full confidence in your children's ability to handle their inherited IRAs.

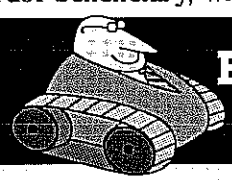
Strategy: If this is the case, each of the smaller "subtrusts" can be structured as conduit trusts, for maximum tax deferral and possible protection of principal.

During your lifetime, you can change the plan if you determine that one of your children needs the protection of an accumulation trust.

Look-back planning: What happens after your death? This point now has been clarified by Letter Ruling 200537044, mentioned above.

This ruling approves an arrangement in which each subtrust can have a "trust protector." The person who serves as trust protector must be unrelated by blood to the trust beneficiary, but may be a financial adviser, attorney, CPA, or friend, for example.

Changing directions: If the circumstances warrant a change (for



BUSINESS WINNERS HOTLINE

$$$ IRS loses. It overvalued estate's holdings in limited liability companies (LLCs). A woman died owning minority interests in four oil-and-gas development LLCs. The IRS and estate both valued the LLCs by comparing their financial ratios (such as price-to-cash flow) with those of comparable public companies. But the estate then applied a much larger discount to the result. *Court:* The LLCs' smaller size, lower operating margins, nonoperator status, dependency on thin outside management, history of capital calls, and a pending arbitration reduced their value compared with that of public corporations, so the estate's valuation is best—and it gets a $2 million tax refund.

W. G. Anderson, DC WD La., No. 02-2168-S.

$$$ IRS loses. Can't set off firm's tax refund against pre-bankruptcy tax bill. Rocor Inc. was a trucking company that paid both heavy vehicle highway use (HVHU) tax and fuel tax, and that filed bankruptcy in the middle of a year. After filing, it became entitled to a $160,000 fuel-tax refund. But the IRS offset that against the HVHU tax payments that it didn't make after the filing. *Key:* The IRS could offset the post-filing refund only against taxes incurred post-filing, not any incurred before the bankruptcy filing. *Court:* Although Rocor owed HVHU payments post-filing, the year's tax bill was determined before the filing by the number of trucks it owned at the start of the year. So, the IRS can't keep the refund.

In re: Rocor International, Inc., Bankr. WD Ok., No. 02-17658-WV.

$$$ IRS loses. Company had insurable interest in its employees' lives. A firm bought whole life insurance policies on the lives of 2,400 employees, borrowed against the policies' cash value, and deducted the interest on the borrowing. But the IRS objected that the company had no "insurable interest" in the lives of its employees (except for key executives), so the policies were invalid. *Court:* The "insurable interest" rule is meant to prevent investors from insuring strangers to obtain a "direct interest in [their] early termination." But here, the insureds all were informed and had granted permission—obviating that risk—and expected to gain from benefits funded by the policies. So, the rule was satisfied.

Xcel Energy Inc, DC Minn., No. 04-1449.

instance, the beneficiary has matrimonial or creditor problems), the trust protector can change a conduit trust to an accumulation trust by voiding the provision that requires the immediate payout of IRA distributions to the primary trust beneficiary.

Result: The trustee will gain the discretion to accumulate funds, and more significant asset protection is afforded the beneficiary.

Other way: Alternatively, the trust protector might switch an accumulation trust (set up for a beneficiary with current problems) to a conduit trust by requiring full payout of MRDs. This might be desirable if the primary trust beneficiary, previously threatened by creditors, now has clear financial skies.

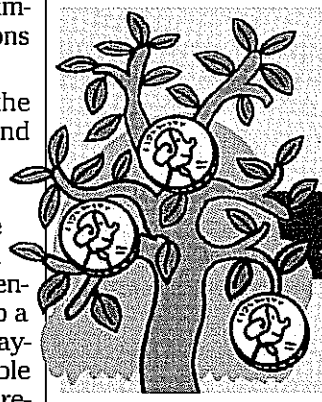
one-shot deal

Such a toggle can be done once, no matter which direction the switch is made. According to the Private Letter Ruling, the one switch can be made within nine months of the IRA owner's death. (It might be argued that, following the letter of the law, a switch is permitted until September 30 of the year after the IRA owner's death, but such a deadline has not been approved by the IRS.)

The trust protector can make this decision, after the IRA owner's death, for each individual beneficiary.

Caution: The IRA Inheritance Trust has been approved in a Private Letter Ruling, which technically applies only to the taxpayer making the request. Although the ruling shows the reasoning of the IRS, work with an experienced tax professional if you're interested in naming such a trust as the beneficiary of your IRA. **TH**

RETIREMENT HOTLINE



Your Own Six-Figure Tax Shelter

A Defined-Benefit Plan

John M. Peterson, CPA, *Goodman & Company, LLP*

If you run your own small business, you can choose among many types of employer-sponsored retirement plans. While defined-contribution plans, such as 401(k)s and profit-sharing plans, get a lot of the press these days, for the greatest up-front tax deductions, a defined-benefit (DB) plan may be your best choice.

Demographics make the difference: Ideal candidates for DB plans are employers in their mid-40s or older. DB plans work especially well if you have a younger staff that is not highly compensated and tends to turn over frequently.

cash commitment

DB plans are traditional pension plans—employers promise to pay retired employees a specific amount of income (the "defined benefit") based on earnings and years of service.

If you are on the payroll of your own company, you'll be among the employees to whom the promise is made.

Loophole: In order to fund the promised benefits, large tax-deductible amounts of money must be put aside each year.

In the situation described above (older owner, younger staff), most of the money going into the DB plan will wind up funding the pension of the owner while relatively little goes to other employees.

Example: In 2006, the maximum benefit payable by a DB plan, as set by law, is a pension of $175,000 per year at retirement. To fund a benefit of that magnitude, a sum of $2 million or more (the amount is determined by an actuary) might be needed at retirement.

If you're age 50, with a target retirement age of 60, your company might have to contribute $125,000 or more per year to fund your pension at that level.

Benefit: This contribution will be deductible from your company's income...

- If you operate a regular C corporation, its income tax will be reduced by this sizable deduction.
- Alternatively, if your company is a pass-through entity, such as an S corporation or an LLC, the deduction effectively will flow to your personal tax return.

close to the vest

Another benefit of DB plans for owners: A DB plan can have, say, a three-year "cliff" (vesting begins at 100% after three years) or a six-year graduated vesting requirement. If an employee leaves before any vesting, the plan retains all the

Tax Hotline interviewed John M. Peterson, CPA, partner, Goodman & Company, LLP, 500 E. Main St., Norfolk, Virginia 23510. A widely published author on retirement plan issues, he is an adjunct professor at William & Mary School of Law, Williamsburg, Virginia, and at Old Dominion University, Norfolk, Virginia, where he teaches courses related to ERISA (the Employee Retirement Income Security Act).