tax IMPACT

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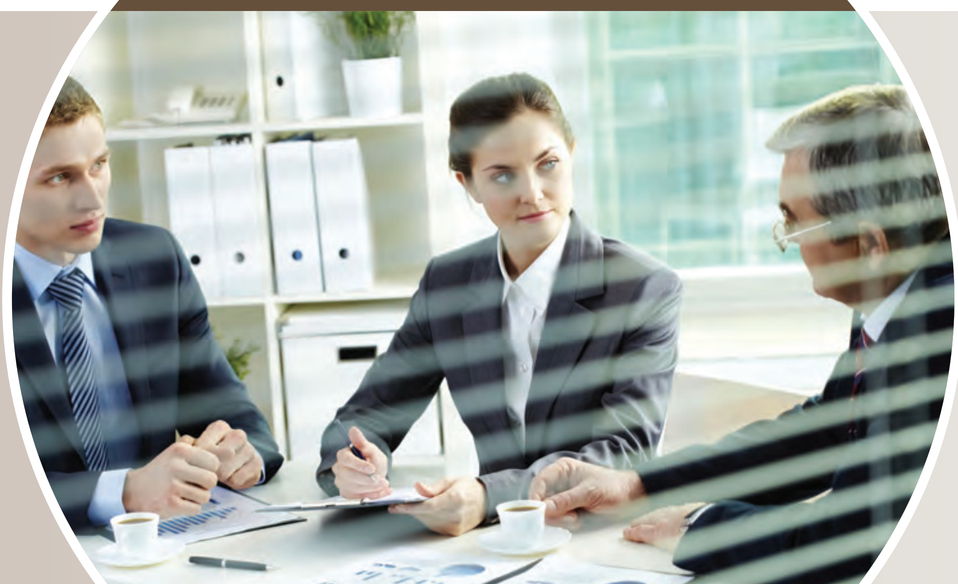

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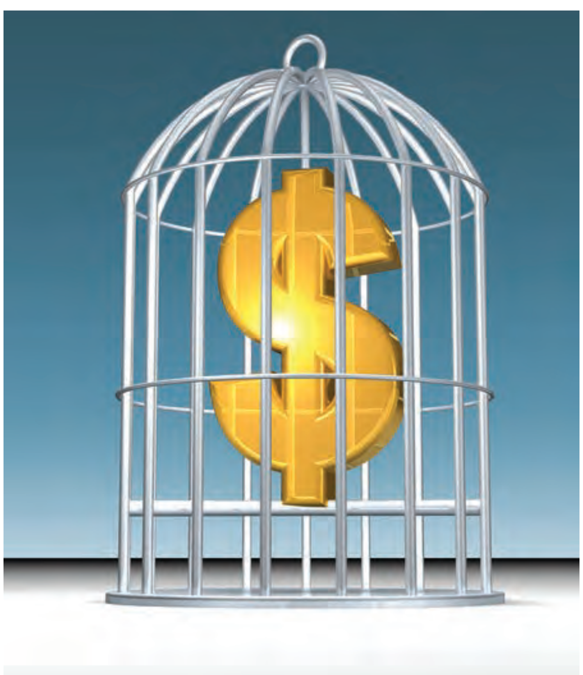
Capturing the benefits of captive insurance

For years, large corporations have used captive insurance companies to control insurance costs. Today, even small, closely held businesses are taking advantage of the many financial, tax and estate planning benefits captives have to offer.

What it is

A captive insurance company is a private insurer owned and controlled by the business or businesses (or the owners of such entities) it insures. Captives may be structured in several ways.

For example, a corporation may set up a captive as a wholly owned subsidiary to insure the parent. Alternatively, a group of related companies with a common parent may set up a captive to cover its members. Or, a group of unaffiliated companies (such as members of an association) may use a captive to pool their risks and share in cost savings and other benefits.



Insurance benefits

The most significant benefit of a captive may be that the owners participate in the captive's underwriting profits and investment income. For example, let's say a business pays a commercial insurer a premium of $1.5 million per year. If the company's claims average $1 million, it's essentially "losing" $500,000 each year.

Captive insurance is a form of self-insurance, but it offers considerable tax advantages over self-insurance.

Suppose instead that the business sets up a captive insurance company and pays that same premium to the captive for comparable coverage. Instead of losing $500,000 per year, the excess accumulates within the captive for the benefit of the owners or their heirs.

What happens if the business experiences $3 million in claims in a given year? Depending on how long the captive has been in operation, it may have sufficient reserves to cover them. But a better approach is to purchase reinsurance for protection against catastrophic losses.

There are other benefits to a captive from an insurance perspective. For example, because the insured parties have control of the captive, they can design customized coverage to best meet their needs. Rather than covering all of a business's insurance needs, for example, a captive might simply cover deductibles or exclusions under commercial policies.

In addition, the owners have control over the claims process and the investment of the captive's assets — two big advantages over conventional policies. And, a captive provides its owners with direct access to the wholesale reinsurance markets.

Captives also can offer more stable premiums and lower fixed costs than traditional commercial insurers can. But that doesn't mean their owners can set premiums at whatever level they desire. To obtain certain tax benefits, a captive must charge reasonable, actuarially supported premiums.

Income tax benefits

Captive insurance is a form of self-insurance, but it offers considerable tax advantages over self-insurance. Ordinarily, commercial insurance premiums are deductible business expenses, while self-insurance reserves are *not*. But you can deduct premiums paid to a captive insurance company, so long as it qualifies as an "insurance arrangement" for federal income tax purposes. (See "What is an 'insurance arrangement'?" at right.)

As an insurance company, a captive can deduct most of its loss reserves, allowing funds to grow on a tax-deferred basis. Even greater benefits are available for a "mini-captive" — one that receives premiums of $1.2 million or less each year.

A mini-captive can exclude premiums from taxable income and pay tax on only its net investment income. This allows it to accumulate surplus from underwriting profits on a tax-free basis. To stay within the $1.2 million limit, it may be possible to set up multiple mini-captives with different owners.

Once a captive has accumulated sufficient reserves, it can pay out dividends to its owners. Because qualified dividends are taxed at favorable long-term capital gains rates, a captive effectively allows business owners to convert ordinary income into capital gains income.

Estate planning benefits

Business owners have much flexibility when it comes to a captive's ownership structure. If a captive is owned by a business owner's children or other heirs, it's possible to transfer large

What is an "insurance arrangement"?

To provide the benefits discussed in the main article, a captive must qualify as an "insurance arrangement" for federal income tax purposes. Among other things, the captive must receive more than 50% of its revenue from issuing insurance or annuity policies. And the arrangement must involve elements of risk shifting and risk distribution.

Risk *shifting* means that the business transfers certain risks to the captive in exchange for a reasonable premium. Risk *distribution* means that risks are pooled with enough other, independently insured risks to minimize the possibility that actual losses will exceed expected losses.

The IRS evaluates captive insurance arrangements on a case-by-case basis, but it has established several safe harbors through revenue rulings. In one ruling, for example, risk distribution existed when a corporation established a wholly owned captive to insure each of 12 operating subsidiaries, none of which paid more than 15% of the premiums.

In another ruling, the IRS found that a wholly owned captive that insures only the risks of the parent doesn't distribute risk. But risk distribution exists if the captive receives less than 50% of its premiums from the parent and the balance from unrelated third parties.

One way to satisfy this requirement is to participate in a risk distribution pool. Such a pool facilitates the exchange of insurance business among multiple captives, allowing them to spread the risk among many insured parties.

amounts of wealth to them free of gift and estate taxes. If the captive owners receive their shares by gift, there may be gift tax consequences, but apart from that they'll enjoy the benefits of the captive's growth free of transfer taxes.

A captive must be organized as a C corporation, but the owners can achieve a variety of estate planning objectives by creating multiple classes of stock or by holding shares in trusts, family limited partnerships or other entities for the benefit of their heirs.

Do your homework

Captive insurance companies offer many benefits, but they're not for everyone. To make this strategy work, you must prepare for the operational and compliance issues the insurance business entails, including licensing, capitalization requirements, investment management, claims management, actuarial reviews, financial statement audits and IRS oversight. ◎

How defined-value gifts can help limit your tax exposure

Making large gifts can be a challenge if they consist of illiquid, difficult-to-value assets, such as interests in a business or family limited partnership (FLP). They must be supported by a business valuation, and there's a risk that the IRS will claim, years later, that a gift was undervalued for tax purposes.

A defined-value gift — which is essentially a gift of assets that equal a specific dollar amount, rather than a fixed percentage of a business or a set number of FLP units — protects against unexpected taxes down the road. Although the IRS has a distaste for defined-value gifts, in recent years some have been upheld by the U.S. Tax Court.

How does a defined-value clause work?

Let's look at an example. Susan sets up an FLP to consolidate the management of her real estate holdings and other investments and to facilitate the transfer of fractional interests to her children while maintaining control. She transfers 30% limited partnership interests to each of her three children, retaining a 10% general partnership interest.

Susan hires a professional appraiser, who determines that the fair market value of the FLP's assets is $5 million. The appraiser values each gift at $900,000 by taking 30% of $5 million ($1.5 million) and deducting a 40% discount for lack of control and lack of marketability. Assuming a 40% gift tax rate and an unused $1 million exemption (and ignoring the annual exclusion), Susan's gift tax liability is $680,000.

Now, suppose the IRS challenged the valuation of the FLP interests and applied a discount of only 20%. In that case, each gift would be valued at $1.2 million, and Susan's gift tax liability would jump to $1.04 million.

If Susan wants to limit her gift tax exposure and is charitably inclined, she could use a defined-value gift that provides for any excess value to go to a charity. Rather than give her kids 30% interests in the FLP, she would give each child a $900,000 interest.

The U.S. Tax Court has drawn a distinction between a savings *clause, which a taxpayer can't use to avoid gift tax, and a* formula *clause, which is valid.*

If her valuation holds up, each child receives a 30% interest. But if the IRS limits the valuation discount to, say, 20%, each child receives a 22.5% interest. The remaining interest — also 22.5% [90% - (3 × 22.5%)] — goes to charity and, therefore, doesn't trigger any additional gift tax liability. To avoid losing control of that interest, the FLP may be able to buy it back at fair market value.

How can it withstand IRS challenge?

Defined-value gifts require careful planning to withstand an IRS challenge. One reason the IRS doesn't like them is that they allow a donor to "undo" a portion of a gift if it turns out to be taxable.

The U.S. Tax Court has sided with the IRS in some cases where a taxpayer used a defined-value clause to reverse completed gifts in excess of gift tax exemptions and exclusions. However, the court has drawn a distinction between a *savings* clause, which a taxpayer can't use to avoid gift tax, and a *formula* clause, which is valid. Savings clauses are void because the taxpayer essentially tries "to take property back." Formula clauses merely transfer a "fixed set of rights with uncertain value." The pivotal question is just what the donor is trying to gift.

In one case, *Wandry v. Commissioner*, once the value of the entity was determined, the percentage interests in the entity were reallocated among the donor and donees in accordance with the specified dollar amounts. Therefore, the court concluded that the couple's defined-value clause was a valid formula clause.

Notably, previous cases that upheld formula clauses generally involved clauses that reallocated interests among the donees, with any transfers in excess of the specified dollar amount going to a charity. According to the Tax Court in *Wandry*, however, it's "inconsequential" that a clause doesn't reallocate the units to a charity if the reallocations don't alter the transfers.

A smart choice for your family?

Defined-value gifts can be a smart choice for families who intend to make large, hard-to-value gifts. But for them to work as planned, an attorney must draft the gift language carefully to ensure that it's interpreted as a formula clause rather than a savings clause. ◎

Undisclosed foreign accounts: Handle with care

Do you own or control any foreign financial accounts — such as bank accounts, brokerage accounts, mutual funds or trusts? If so, it's critical to understand your reporting obligations.

Reporting requirements

If you have a financial interest in or signature authority over any foreign accounts or certain other foreign assets, you must:

- Disclose their existence by checking the box on line 7a of Schedule B ("Interest and Ordinary Dividends") of Form 1040.
- Provide account details on Form 8938 — "Statement of Specified Foreign Financial Assets" — if the total value of your specified foreign financial assets exceeds $50,000 ($100,000 for joint filers) at the end of the tax year or exceeds $75,000 ($150,000 for joint filers) at any time during the tax year.
- File FinCEN (Financial Crimes Enforcement Network) Form 114 — "Report of Foreign Bank and Financial Accounts (FBAR)" — if the aggregate value of your foreign accounts exceeds $10,000 at any time during the calendar year. The form must be filed electronically with FinCEN no later than June 30 of the following year.

If you fail to comply, the IRS can go back three or six years (depending on the applicable statute of limitations) to collect back taxes, interest, a 20% or 40% accuracy-related penalty and, in some cases, a 75% fraud penalty. In addition, nonwillful failure to file FBARs is subject to penalties up to $10,000 per year. Willful violation carries a penalty up to the greater of $100,000 or 50% of the account value. You could even be at risk for criminal prosecution.

What to do about it

If you have undisclosed foreign accounts, consider entering the IRS's Offshore Voluntary Disclosure Initiative (OVDI). Given the IRS's aggressive efforts to uncover hidden foreign accounts, entering the OVDI is likely a good idea. You avoid criminal prosecution and generally pay lower penalties than you would if the IRS discovered the accounts.

Under the current program, you pay up to eight years of back taxes plus interest, a 20% accuracy-related penalty and a penalty equal to 27.5% of the highest account balance in the previous eight years. The 27.5% penalty is subject to certain limited exceptions that could reduce it to as low as 5%. Once you've entered the OVDI, you can opt out if you believe your liability would be lower outside the program.

Don't risk the penalties

As you can see, reporting your offshore accounts to the IRS is essential. Your tax advisors can help you weigh your options and choose the best strategy. ◎

tax TIPS

Business owners: Hire your kids to save taxes

If you hire your children, they're under 18 and your business is unincorporated, neither the business nor the kids have to pay Social Security or Medicare taxes on their wages. Shifting income to your children this way can also reduce your family's income tax bill because your kids are likely in a lower tax bracket. ◎

Are you eligible for an in-plan Roth rollover?

Roth accounts in 401(k), 403(b) or 457(b) plans can offer tax advantages over traditional retirement accounts, especially for taxpayers whose incomes are too high for them to contribute to a Roth IRA. Plans that include a Roth option can allow employees to roll over amounts from their traditional accounts into a designated Roth account (subject to tax on the amount rolled over).

But until recently, these in-plan rollovers were limited to employees who were eligible for a distribution (because, for example, they had reached retirement age or had left the company). Now plans may allow *any* employee to roll over eligible amounts into a Roth account. ◎

Tax Court upholds net gift arrangement

In a recent decision, the U.S. Tax Court, overruling a previous Tax Court decision, held that a gift's value for gift tax purposes may be reduced if the recipient agrees to assume the donor's potential estate tax liability. Under federal law, if a donor dies within three years of making a gift, the property is pulled back into his or her taxable estate. In *Steinberg*, the court allowed the donor to reduce the value of her gift by the actuarial value of the recipients' obligation to pay any potential estate taxes. This case may open the door to new estate planning strategies using "net gifts." ◎

100% deductions for certain M&E expenses

Generally, businesses are limited to deducting 50% of allowable meal and entertainment (M&E) expenses. But certain expenses are 100% deductible, including expenses:

- For food and beverages furnished at the workplace primarily for employees,
- Treated as employee compensation,
- That are excludable from employees' income as de minimis fringe benefits,
- For recreational or social activities for employees, such as holiday parties, or
- Paid or incurred under a reimbursement or similar arrangement in connection with the performance of services.

If your company has substantial M&E expenses, you can reduce your tax bill by separately accounting for and documenting expenses that are 100% deductible. If doing so would create an administrative burden, you may be able to use statistical sampling methods to estimate the portion of M&E expenses that are fully deductible. ◎

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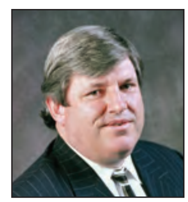

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Card, Palmer, Sibbison & Co. has been serving as a trusted advisor and management consultant to owners and businesses in Northeast Ohio since 1920. We have expertise in both the privately held company and not-for-profit area. As certified public accountants we perform the traditional financial and tax services but also provide a wide array of other business services.

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