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TAXES

Getting Insurance For Your Tax Bill

As IRS Targets Shelters, Carriers Offer Coverage in Case A Strategy Doesn't Pass Muster

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There's insurance against theft, fire and even earthquakes. Now comes protection from another fear-inducing event: an adverse ruling by the Internal Revenue Service.

Amid the crackdown on tax shelters, an array of companies are offering policies designed to cover tax bills that arise when the government challenges a particular deduction or transaction. The insurance is often used for situations that spring from gray areas in the tax code. Though most of the policies were originally geared toward corporations, they've been attracting greater interest from family businesses and even individuals.

Insurers and attorneys say they have been getting more queries about the products in recent months. Some big names, including **Aon Corp.** and **Marsh Inc.**, a unit of **Marsh & McLennan Cos.**, are among the brokers that arrange the coverage.

"The interest is increasing as people are more sensitive about tax planning these days than they have been in the past," says Jay Gordon, who is chairman of the tax practice at law firm Greenberg Traurig, and who has seen a recent rise in client inquiries about tax insurance.

TAX PROTECTION

Individuals and families might consider tax insurance in the following situations:

- To protect a buyer or seller from unwanted tax bills when a family business is being sold.
- To preserve a tax deduction when donating art or valuables to a charity.
- To protect gift-tax savings in a family limited partnership.
- To avoid tax hits on matters that the IRS has declined to rule on.

Another factor: The IRS used to view tax insurance as a red flag, a so-called reportable transaction, signaling that the policyholder might be protecting a tax shelter. Last year, however, after IRS and Treasury officials conducted a public hearing on the matter, the IRS changed course and effectively removed tax insurance from the list of reportable transactions. But some regulators are cracking down harder. Just last month, California launched an investigation into tax-insurance policyholders.

The insurance can be used to cover a buyer or seller from a potential tax hit when a family business is sold or a piece of it is spun off. Last year, the IRS stopped granting, at least for now, certain "private-letter rulings" -- in essence, pre-approvals that a particular spinoff was conducted for a legitimate business purpose and thus was not taxable. That drove more businesses to seek tax-insurance coverage to pay the difference in case the IRS didn't bless the deal.

A policy might also protect against other tax-related uncertainties, such as how limited-partnership shares are valued for gift or estate-tax purposes. If the IRS challenges the valuation of this type of asset, a policy could cover all or part of the tax owed. One caveat: Most policies won't protect you if the tax law changes.

A wealthy family might seek coverage if they donate their art collection to a charity and they want to make sure they'll get the maximum deduction they're seeking, says Nemo Perera, managing partner of Risk Capital Partners. The firm, a boutique insurance brokerage, provides tax insurance for the estate planning and wealth-management strategies of well-heeled individuals and families. It now examines about 20 different transactions a month, compared with half that a year ago.

Insurers insist they don't cover tax shelters, which are transactions with no real business purpose besides avoiding taxes. The deals have to be safe enough for insurers to back them up with their capital. "By buying tax insurance, what you are saying is that you brought in an unrelated third party who put their money at stake and assessed it as a low risk," says Richard Wolfe, a tax partner at law firm Fried, Frank, Harris, Shriver & Jacobson.

In another move that has helped drive the increased interest in tax insurance, the IRS late last year proposed to clamp down on so-called opinion letters. In these documents, tax advisers state that a tax structure is likely to pass muster in an IRS audit. In the past, many taxpayers used such letters to help avoid tax penalties, claiming that they relied on the advice of a professional adviser to devise the tax strategy.

With opinion letters a less viable option, tax insurance has grown more attractive as a way to protect against unwelcome tax penalties. The policies generally cover penalties, as well as federal, state, local or foreign taxes due, and legal costs if the tax strategy ends up being challenged. Policies usually last for about six years, or the statute of limitations for the deal being covered.

Tax insurance doesn't come cheap. Premiums are usually one-time, nonrefundable charges that range from about 5% to 11% of the coverage amount. Most insurers have minimum premiums of at least \$100,000 to \$250,000, which means that the policies make sense only for customers worried about multimillion-dollar tax hits. Most policies have negotiable deductibles so the policyholder is on the hook for at least a portion of any of the taxes. There are also extra due-diligence fees of \$25,000 to \$100,000 or more, depending on the size and complexity of the transaction.

With all those costs, some financial advisers say the insurance policies might not be worth it. After all, if the insurer is willing to provide coverage, the transaction might be safe enough to wing it without paying pricey premiums and other fees. By the time you add up all the costs, "the client is going to be shelling out up to 20% to 40% of the tax anyway," says Robert Slane, president of Wealth Transfer Group, Altamonte Springs, Fla., an estate-planning advisory firm for wealthy families.

Insurers such as **Hartford Financial Services Group Inc.**, **American International Group Inc.**, and Ambridge Partners are underwriting such coverage, mainly for businesses.

Mr. Perera of Risk Capital Partners says that he rejects at least 60% of the potential deals that cross his desk because they are too shaky. Hartford Financial insures only between 10% and 30% of the submissions it receives, says company vice president David De Berry.

Still, tax insurers and their customers have recently caught the eye of regulators. Last month the California Franchise Tax Board subpoenaed two major insurance companies for client lists to determine whether any California customers, either businesses or individuals, were insuring shady tax shelters. The subpoena, for records from 1999 to 2002, is part of a broader state effort to crack down on abusive tax shelters.

Denise Azimi, a spokeswoman for the California Franchise Tax Board, said the subpoenas aren't aimed primarily at the insurance companies, but rather at the customers who might have insured abusive tax shelters. She added that the names of the two insurers are confidential. However, a U.S. Senate subcommittee report on tax shelters, issued late last year, named AIG and Hartford Financial in connection with shelters sold by accounting firm KPMG LLP.

Cynthia Michener, spokeswoman for Hartford, said the company had received the California subpoena and intends to "respond appropriately."

"To our knowledge we have never insured a tax product promoted by KPMG," she says. An AIG spokesman declined to comment on regulatory matters.

Despite no longer viewing such policies as an automatic red flag, the IRS hasn't turned a blind eye to tax insurance. In a March 2003 Internal Revenue Bulletin, the IRS warned that if it comes to its attention that tax insurance is "being used to facilitate abusive transactions, changes to the regulations will be considered." An IRS spokesman declined to comment beyond the new regulations.

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