

A Shield for Shelters

New tax mitigation strategies can be safeguarded from adverse IRS rulings with an age-old financial technology: insurance.

By Nemo Perera

MANY OF US HAVE ENCOUNTERED sophisticated financial planners who claim to have created bulletproof tax-avoidance techniques to help protect and grow our assets without undue risk of scrutiny from the IRS. Unfortunately, nothing in the tax-planning world is armor plated—especially now. Regulations that went into effect on December 30 stripped away the safety net formerly provided by the generic opinion letters offered by the promoters of these tax-advantaged techniques. These documents, at one time given as proof of the strategies' legality, will no longer be enough to satisfy the IRS. Should a strategy fail to pass IRS muster, we could now face much more onerous financial risks.

In the past, if we used an opinion letter to prove that we relied on the counsel of a professional advisor to devise a tax-mitigation strategy that the IRS later ruled to be improper, the government would only demand the actual taxes due. Because it would not levy an additional penalty, we assumed very little risk. The new rules change that. IRS Commissioner Mark W. Everson says the new rules attempt to quash what he called the "lucrative trade in opinion letters, which taxpayers buy in the expectation that they can get penalties waived if their strategy is disallowed." The new regulations also bar a taxpayer from relying on opinion letters from advisors who have a financial interest in the tax-minimization transaction. For example, a lawyer affiliated with an advisor who would win a deal (say an asset management mandate) on the basis of the transaction's tax benefits could not issue an opinion letter on it. Also, it has been common practice for law firms to actually earn commissions on transactions they bless with opinion letters. This is no longer tolerated.

Although many have applauded the new regulations as a needed reform, their unfortunate byproduct is the fear and hardship they have created for those who have already engaged in legitimate strategies. Many wealthy families and successful business owners are therefore settling for ultraconservative approaches, reluctantly passing on legitimate tax savings. The fear of attracting unwanted attention also has restricted the creativity of many financial planners, leaving them reluctant to structure even nonaggressive strategies that could further a client's wealth preservation goals. If legal opinion letters cannot provide comfort, what will?

Although it is common to insure a home, car, boat or airplane against the risk of loss, many taxpayers and their advisors are unaware that they can insure wealth preservation

strategies against a potential tax liability. Tax insurance (which is available for legitimate transactions only, not abusive tax shelters) assures that the client will indeed receive the specific tax benefit devised by a credible tax advisor.

COVERING YOUR ASSETS

Risk Capital Partners, a specialty insurance brokerage and consultancy, has reengineered traditional tax insurance in cooperation with leading insurance carriers to specifically address the tax risks associated with legitimate wealth preservation techniques. These insurance policies are typically structured to cover the entire statute of limitations period under the tax code for a transaction, and can be designed for both past and current transactions. Policy limits can be set to include unanticipated legal costs, penalties and fines, in addition to any actual taxes that might be due. Tax insurance transfers all the risks to the insurance company for a one-time premium payment, which is typically a single-digit percentage of the total tax and penalty liability.

TAX INSURANCE BENEFITS:

- **Direct validation of the transaction's integrity by a well-known insurance carrier (a conservative third party entity that is not compensated by the tax-advantaged transaction itself).**
- **Indirect validation of the financial planner's integrity.**
- **Ability to lock in profits without the fear of future IRS action negating anticipated returns.**
- **Coverage for both future and previously completed transactions.**
- **An alternative to legal opinion letters and an innovative means of verifying the validity of an existing legal opinion.**
- **A green light when an IRS Private Letter Ruling is not wanted or not available. (A PLR is a letter issued by the IRS that blesses a transaction; securing a PLR usually requires a very long and costly process.)**



Tax insurance is a testament to a deal's propriety because it shows that a conservative insurance underwriter was willing to risk its own capital and that of its reinsurers on the validity of a tax strategy.

Tax insurance is not widely understood, most likely because those legal and accounting advisors most suited to suggest this option—the purveyors of opinion letters—would find it difficult to charge fees for authoring a comfort letter and then later advise that the same opinion should be insured.

The IRS view of tax insurance is, surprisingly, supportive. While it might seem as if it would regard tax insurance as a red flag for questionable transactions, the opposite is true. The IRS views tax insurers as the only nongovernmental entities motivated to judge tax positions conservatively. Tax insurers are not paid for providing artful opinions or for promoting creative transactions. Instead, they are compensated for prudently assessing a tax position. Tax insurance is a testament to a deal's propriety because it shows that a conservative insurance underwriter was willing to risk its own capital and that of its reinsurers on the validity of a tax strategy. William O'Shea, a deputy associate chief counsel at the IRS, has stated: "There are a lot of legitimate reasons for having tax insurance. Really it is more like a green flag."

The IRS issued final regulations regarding tax insurance, called Section 6011 transactions with contractual protection, in April 2003. The regulations, made retroactive to February 28, 2003, approved the use of insurance for legitimate transactions.

SHIFTING THE RISK

How does tax insurance work? Suppose that John Taxpayer owns a company valued at \$200 million. Following professional advice, he causes the company to establish an employee stock ownership plan, and he sells half of his stock to the

ESOP for \$100 million. He then invests the proceeds in a special-purpose security, and borrows \$90 million against that asset, which he invests in a diversified portfolio of liquid investments. His advisors say this transaction will allow him to avoid \$25 million of federal and state taxes on the gain he realizes on the sale of stock. In this kind of case, he can buy a cost-effective tax insurance policy that would provide \$35 million of protection, locking in his anticipated tax savings and providing coverage for any possible penalties or fines. This protects his tax benefit, but perhaps even more importantly, it provides certainty—and the peace of mind that goes along with it.

In some cases the window of opportunity to insure tax liabilities is limited by new legislation. For this reason, individuals should consider obtaining insurance at the same time a strategy is evaluated. In doing so, the taxpayer has indirectly commissioned a risk assessment of the transaction before entering into it. If it can be insured cost effectively, it makes sense to move ahead. If it cannot, the entire transaction should be reevaluated. Past transactions can be insured retroactively, but must be evaluated, using the same criteria as new transactions, on a case-by-case basis.

In an environment in which tax authorities are increasingly skeptical about the validity of opinion letters, wealthy individuals and their advisors can consider tax insurance as a useful risk-mitigation tool. ■

Nemo Perera is a senior executive at Risk Capital Partners, a boutique insurance brokerage and consultancy with a specialty in insuring tax strategies designed for wealthy families and major corporations. (212.496.7478, nemo.perera@rcps.com)