PROFESSIONAL ADVISOR UPDATE

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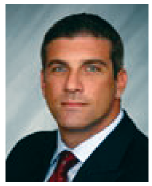

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Aggressive Tax Avoidance Schemes Waiting for us at the Bottom of the Fiscal Cliff

We delayed putting together the December Professional Advisor Update, as we had hoped by this time we would be able to provide a summary of the grand bargain reached between the White House and Congress addressing the fiscal cliff. Forgive us for our meritless optimism. So, instead of in-depth analysis of new tax laws, we thought we'd throw out a simple word of caution. While waiting for an answer on a litany of tax issues, the dialogue we have had with other professionals has brought up an interesting concern – the desire for clients to seek out aggressive tax strategies and the pressure advisors will feel to implement these strategies.

The setting is familiar – increasing tax rates for high wage earners, a politically left-leaning environment for the foreseeable future, a series of new tax laws with a few holes yet to be filled by the IRS and Treasury, and substantial increases in wealth at the top (even with a sluggish economy). These factors were present in the mid 1990s and are likely to be present in coming years. In the mid 1990s these factors resulted in a noticeable increase in requests from clients for ways to reduce their tax exposure, new aggressive tax avoidance "strategies" engineered by individuals looking to take advantage of this desire, and pressure on advisors to approve of and implement aggressive strategies. While the IRS has become increasingly efficient at discovering and eliminating the more egregious schemes, can we expect more "inventiveness" in the coming years?

Throughout the past few decades we have seen many strategies that promote tax advantages not available in traditional financial arrangements. We've worked with legal and tax advisors to determine which strategies simply took advantage of existing law, which ones violated the spirit of the law, and which ones simply ignored the law and hoped the taxpayer would not get caught. These included charitable split dollar programs, 419A(f)(6) multi-employer welfare benefit plans, 419(e) single employer welfare benefit plans, 412(i) plans with springing cash values, rabbicular trusts, reverse split dollar programs with inflated economic benefit rates, variations of Sec. 79 plans and a long list of others. The IRS and Treasury addressed each of the plans mentioned above but, as quickly as they act, another plan pops up claiming to provide similar tax advantages.

In October of 2009 the IRS announced the creation of the Global High Wealth Industry Group, which was established to target high net worth individuals. The concern expressed by the IRS is that these individuals use more sophisticated arrangements to hide income and the agents previously tasked with auditing these returns did not have the experience necessary to discover abuses. This new team is staffed with more experienced agents dedicated to reviewing these tax returns. This, along with other efforts from the IRS aimed at curbing tax-avoidance schemes, will make it more risky for clients and their advisors to take aggressive positions. While the IRS audit rate for individual returns of persons earning less than $200,000 remains at about 1 percent, the audit rate for individual taxpayers with incomes of $1 million or more was 12 percent in 2011, which is double the rate in 2009.

As the saying goes: pigs get fat; hogs get slaughtered. There are many well-established financial strategies that provide significant advantages for those who will face increased income tax rates (or capped deductions). While they may not have the marketing appeal that more aggressive tax avoidance schemes have, they are effective and they keep you and your clients out of the IRS crosshairs. Financial products such as cash value life insurance, annuity products and newer hybrid products that provide a combination of tax-efficient savings and long-term care insurance benefits will look very appealing in the coming years and won't cause your clients to labeled "defendant" anytime soon. A note of caution however – while these products enjoy tax advantages that have been on the books for decades, there is no guarantee they will continue to enjoy these advantages in the future. There has been an increased desire on the part of lawmakers to eliminate some of the tax expenditures currently on the books. This places a number of the tax advantages enjoyed by the financial products mentioned above at risk.

So, as we await the final temporary word from Washington, we can expect our high wage-earning clients to display an increased passion for tax avoidance. But before we introduce them to the scheme-of-the-month with the 50-page tax opinion written by the brother in-law of the marketing organization that developed the strategy, we should first take a look at some of the simple solutions available through financial products that enjoy well-established tax advantages – advantages that will be enhanced as these clients face additional tax burdens.

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