Tax and Business Alert™

June 2012

Tax-free Exchanges of Life Insurance Policies

A periodic life insurance review is essential to ensure life changes have not altered the original intent for purchasing a policy, cover new or additional requirements, address concerns about the financial soundness of the insurer, and deal with various other issues. However, replacing a life insurance policy can create adverse federal income tax consequences. Specifically, a taxable gain can result if the policy is surrendered when its cash surrender value is greater than the tax basis in the policy. The policy's tax basis is typically the total premiums paid less any tax-free distributions, e.g., dividends or the surrender of part of the policy.

With careful planning, however, a policy exchange that qualifies under Internal Revenue Code Section 1035, known as a "1035 exchange," can be used to replace one life insurance policy with another. Any gain or loss generated upon such an exchange is not recognized currently for income tax purposes.

As previously noted, individuals may consider replacing or exchanging life insurance policies for a number of reasons. One of the more important reasons is the financial strength and soundness of their insurance company. Individuals whose policies are held by companies with questionable stability often want to replace them with those of companies deemed more financially sound, usually based on the ratings of companies that rate insurance company financial strength. Replacement with policies from a more financially viable company may avoid a future loss of benefits or value in the event the initial insurer becomes insolvent.

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Some policy holders benefit from replacing a policy with one that provides an increased rate of return. The fees charged by insurers may also be a factor since they affect the policy's rate of return. Individuals who own multiple policies may want to combine those into fewer, larger policies to ease the administrative burden of maintaining them. Finally, an individual's financial needs may change, making one type of contract or policy more desirable than another.

Individuals contemplating a 1035 exchange of policies should be aware of certain disadvantages of making an exchange. With respect to a life insurance policy, an exchange for another policy may start a new incontestability period (the period of time the

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Use a Reverse Mortgage as a Cash Resource

When an older homeowner has significant equity in his or her residence and needs funds, but lacks the resources to make monthly payments on a conventional mortgage, a reverse mortgage might provide a solution. A reverse mortgage is so-called because the mortgage balance normally increases over the term of the loan, rather than decreasing as the balance of a conventional mortgage does. A reverse mortgage allows a homeowner to receive loan proceeds over a certain period (by borrowing against equity in the home) while continuing to live in the house. (Other loan distribution options are available.)


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An older homeowner may be motivated to obtain a reverse mortgage for many reasons. These include paying off an existing mortgage; purchasing a new residence; paying taxes, medical expenses, insurance, and household upkeep costs; covering financial emergencies; supplementing monthly income; paying nursing home expenses; and providing rainy day funds.

The amount a lender will advance depends primarily on the borrower's age, equity in the home, and the interest rate. The older the homeowner, the larger the advances can be because there will probably be fewer advances than a younger homeowner would receive. Also, the more equity in the home, the larger the monthly advances can be. Finally, a lower interest rate can lead to larger advances.

In a typical case, the house will be sold at some point (normally after the borrower dies) to pay off the mortgage. Since the loan typically defers all repayment until the house is sold or the borrower dies, lending decisions may be based primarily on the home's value rather than on the borrower's creditworthiness and ability to make monthly payments as in the typical loan underwriting process.

In most cases, to qualify for a reverse mortgage, the homeowner must be at least 62 years old. He or she must also own the home outright or be able to pay off any balance with a portion of the reverse mortgage proceeds. To avoid default, the homeowner must maintain the home, pay property taxes, and provide insurance.

Caution: The expenses associated with reverse mortgages are high. Homeowners could pay as much as 7% to 8% of their home's value in closing costs as well as a higher interest rate than with a regular mortgage or home equity loan.

"Dirty Dozen" Tax Scams

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9. *Falsely Claiming Zero Wages.* Filing a phony wage-related or income-related information return to replace a legitimate information return has been used as an illegal method to lower the amount of taxes owed.

10. *Abuse of Charitable Organizations and Deductions.* Misuses of tax-exempt organizations include arrangements to improperly shield income or assets from taxation, attempts by donors to maintain control over donated assets or income from donated property, and overvaluation of contributed property.

11. *Disguised Corporate Ownership.* In this scam, domestic corporations and other entities are formed to disguise the ownership of a business. They are then used to under-report income, claim fictitious deductions, avoid the filing of tax returns, or participate in listed transactions, money laundering, financial crimes, and even terrorist financing.

12. *Misuse of Trusts.* Unscrupulous promoters have urged taxpayers to transfer assets into trusts, promising reduced taxable income, deductions for personal expenses, and reduced estate or gift taxes that don't deliver as promised.

Please contact us if you are concerned about these or any other questionable activity.

S Corporation Profiles

In certain business and tax scenarios, electing S corporation status for your business can be advantageous. In other scenarios it may not be beneficial. We discuss below some of the more common scenarios taxpayers may encounter in making their decision to elect S corporation status or use another entity structure for their business.

Taxpayers should recognize the general situations that lend themselves to electing S status. A frequent scenario involves a new business that is expected to incur losses during the initial start-up period. Assuming sufficient basis (e.g., stock investment) exists, the losses passed through to the shareholders can be deducted on their personal returns. S corporation stock is eligible for Section 1244 treatment, so if the venture is unsuccessful and the stock is later sold or exchanged at a loss, ordinary loss treatment is possible versus less favorable capital loss treatment.

A profitable, cash-rich closely held corporation is a likely candidate for an S election, particularly a personal service corporation (e.g., physician or lawyer). An accumulation of cash enables the corporation to make distributions to the shareholders to pay the income tax generated by the pass-through income from the S corporation. Personal service corporations are not eligible for the graduated corporate tax rates, and electing S status will minimize exposure to an unreasonable compensation issue.

An established corporation in a mature industry may want to consider electing S status. As earnings growth slows and reinvestment in plant and equipment falls, the corporation may accumulate earnings even if substantial dividends are paid. S status enables the corporation to avoid double taxation on the distributions to shareholders and eliminates exposure to the corporate-level accumulated earnings tax.

Taxpayers should also recognize the general situations that lend themselves to forgoing the S election. A rapidly growing corporation in a competitive, expanding market may not benefit from the S election. The profits earned by the corporation will be passed through to the shareholders and may be taxed at a higher rate than if taxed at the corporate rates. However, the corporation may not have the cash to pay the resulting shareholder income tax liability, because of heavy research and development costs or reinvestment in plant and equipment.


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If most of a corporation's shareholders are employees, it may want to remain a C corporation. Common fringe benefits provided to the shareholder/employees will be taxable if the corporation elects S status.

An S corporation may be severely limited in its ability to raise outside capital because of the 100-shareholder limitation and restrictions on eligible shareholders. Furthermore, the one-class-of-stock limitation prevents an S corporation from issuing preferred stock to outside investors (or to the older generation in a family-controlled corporation). The corporation's existing shareholders may not want outside investors to participate in the future growth of the corporation, while the outside investors may want the steady income stream generated by preferred stock or may be unwilling to invest unless the stock is convertible or participating preferred.

Obviously, this article is technical in nature, but making an S election requires a thorough analysis of all pertinent facts. Please contact us if you have questions on whether to elect S status or to discuss any other tax compliance or planning issue.

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insurer has specific rights to deny a claim). There may also be disadvantageous provisions within the new policy. Finally, additional fees and other costs may be associated with an exchange.

Note: The 1035 exchange provision applies to life insurance, annuity, and endowment contracts. Qualifying exchanges include not only policies of the same type, but also, in some cases, policies of different types.

"Dirty Dozen" Tax Scams

IRS Commissioner Doug Shulman recently stated "taxpayers should be careful and avoid falling into a trap with the Dirty Dozen. Scam artists will tempt people in-person, on-line


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and by e-mail with misleading promises about lost refunds and free money. Don't be fooled by these scams."

The Dirty Dozen are the 12 most prevalent scams detected by the IRS. Taxpayers should take precautions to avoid these and other suspicious activities of scam artists. The following scams make up the IRS's 2012 "Dirty Dozen" listing.

1. *Identity Theft.* Topping this year's list is identity theft. The IRS is increasingly seeing identity thieves looking for ways to use a legitimate taxpayer's identity and personal information to file a tax return and claim a fraudulent refund.

2. *Phishing.* Phishing is a scam typically carried out with the help of unsolicited email or a fake website that poses as a legitimate site to lure potential victims and prompt them to provide valuable personal and financial information that can be used to commit identity or financial theft.

3. *Return Preparer Fraud.* Questionable return preparers have been known to skim off their clients' refunds, charge inflated fees for return preparation services, and attract new clients by promising guaranteed or inflated refunds.

4. *Hiding Income Offshore.* Individuals continue to try to avoid paying U.S. taxes by illegally hiding income in offshore accounts or using offshore debit cards, credit cards, wire transfers, foreign trusts, employee leasing schemes, private annuities, or insurance plans.

5. *"Free Money."* Scammers have been preying on low-income individuals and the elderly by posting flyers in community churches promising that tax returns can be filed with little or no documentation to receive "free money" from the IRS or Social Security Administration.

6. *False/Inflated Income and Expenses.* This tactic is used by scam artists who file false or misleading returns to claim refunds they are not entitled to receive. One popular scam is to report income that was never earned to obtain refundable credits.

7. *False Form 1099 Refund Claims.* In this scam, the perpetrator files a fake information return reporting false withholding amounts that are subsequently used to file erroneous refund claims.

8. *Frivolous Arguments.* Frivolous scheme promoters encourage people to make unreasonable and unfounded claims to avoid paying taxes.

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