Tax Impact

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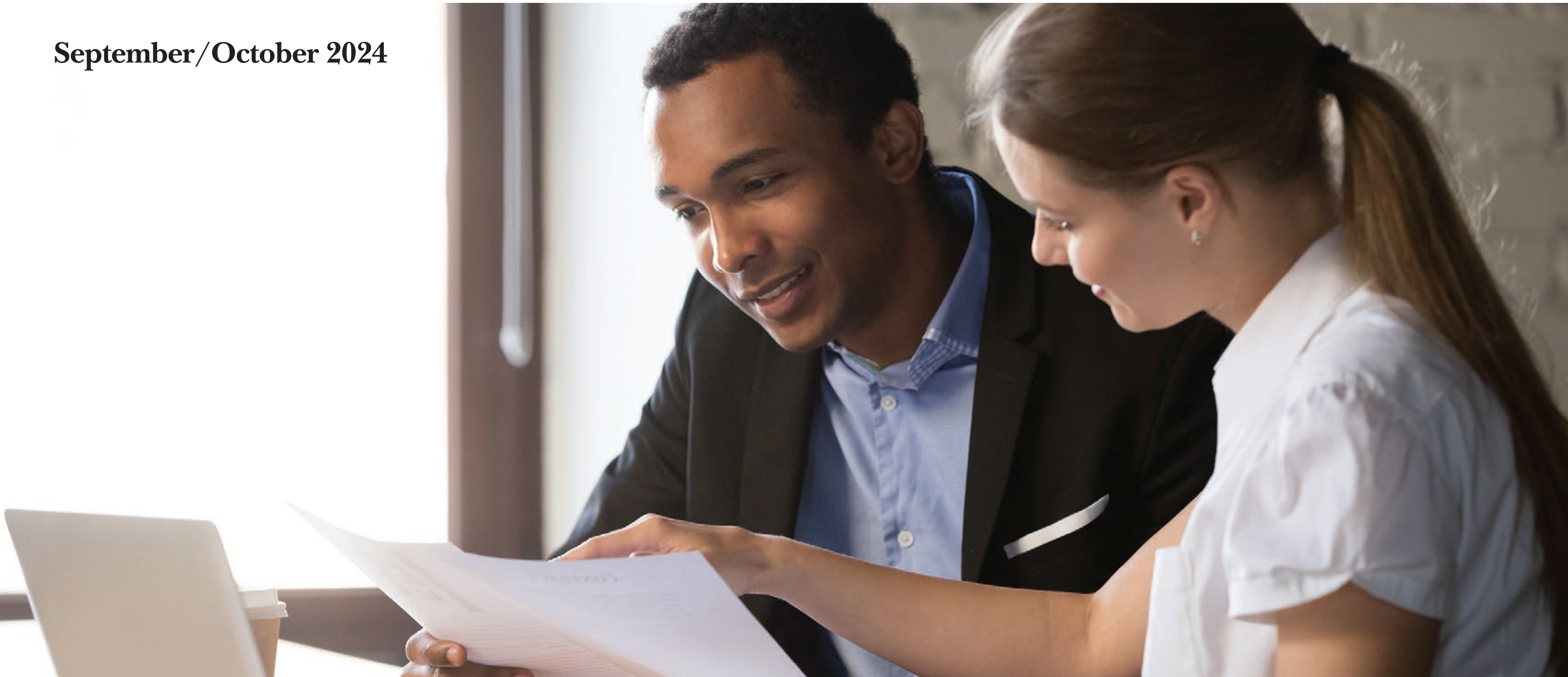


A captive can reduce your insurance costs … and your tax bill

Undoing an ILIT is possible in certain situations

Are energy-efficient home improvement rebates taxable?

Tax Tips

A captive can reduce your insurance costs … and your tax bill

In the current business environment, many companies are finding it difficult — or prohibitively expensive — to secure the insurance coverage they need. One solution that may be worth exploring is to form or join a captive insurance company.

Simply put, a captive is a licensed insurance company that's owned and operated by the business or businesses it insures. Although a captive can be a subsidiary owned by a single parent company, a group captive is usually the most attractive option for small and midsize businesses. It allows multiple organizations to share the risks, costs and liabilities. For example, a trade association might form a captive insurance company for its members.

Under the right circumstances, a captive can provide its members with a cost-effective alternative to purchasing insurance in the commercial markets. It may also offer some significant tax benefits.

Potential risk management benefits

Although it's possible for a captive to replace traditional commercial policies, it's more common for members to use captive insurance to supplement existing commercial coverage, such as general liability, workers' compensation or automobile coverage. For example, a captive might cover losses within a specified deductible or retention amount.

Benefits of captive insurance for members include:

- Access to coverage that may be unavailable from traditional insurers or, if available, may come at a high cost,
- The ability to tailor coverage to meet members' specific needs and avoid paying for coverage they don't need,
- Direct access to the wholesale reinsurance market, and
- Greater control over the claims review process.

In addition, members participate in underwriting profits that otherwise would go to a traditional insurance company. And they share in any investment income earned on the captive's premium reserves.

Tax benefits

Although captive insurance shares many similarities with self-insurance, a captive that qualifies as an "insurance arrangement" for federal tax purposes enjoys some significant tax advantages. Unlike reserves set aside under a self-insurance program, premiums paid to a captive are deductible by its members. And the captive, as an insurance company, can deduct its reasonable loss reserves. So-called "microcaptives" offer additional tax benefits, although they can expect to

Microcaptives: Handle with care

A microcaptive is a captive insurance company that's eligible for tax benefits available to "small" insurance companies. To qualify, a captive's annual premiums can't exceed a specified threshold ($2.8 million in 2024). In addition, it must meet the Internal Revenue Code's diversification requirements. Among other things, this means that no single policyholder can contribute more than 20% of the captive's annual premiums.

Small insurance companies, including eligible microcaptives, may elect to be taxed on *only* their net investment income. In other words, their underwriting profits escape taxation at the federal level.

The tax advantages of a microcaptive are significant. That's because the business or businesses that own the captive may deduct their premium payments to the captive, but the captive isn't taxed on its premium income.

However, be aware that in recent years the IRS has been scrutinizing microcaptive arrangements and challenging those it views as mere tax avoidance schemes. According to the IRS, abusive microcaptives "involve schemes that lack many of the attributes of legitimate insurance. These structures often include implausible risks, failure to match genuine business needs, and in many cases, unnecessary duplication of the taxpayer's commercial coverages. In addition, the 'premiums' paid under these arrangements are often excessive, reflecting non-arm's-length pricing."

be scrutinized by the IRS. (See "Microcaptives: Handle with care" above.)

To be considered an insurance arrangement, a captive must meet several requirements. Most important, the arrangement must achieve risk shifting and risk distribution.

Generally speaking, risk shifting means that members transfer 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. In addition, the captive must set premiums properly based on actuarial and underwriting considerations, be adequately capitalized, and be created for legitimate nontax reasons (among other requirements).

A captive can also be an effective estate planning tool. By providing family members with ownership interests in a captive, business owners can potentially transfer wealth to their heirs free of gift and estate taxes.

A formidable undertaking

Before taking action, know that forming and operating a captive isn't a simple task. It requires owners to invest start-up capital, assume risk, comply with applicable regulations, and file state and federal tax returns. Owners must also manage the captive's insurance business, which includes issuing policies, calculating and collecting premiums, setting aside reserves, and processing and paying claims. Many captives outsource day-to-day management activities to a captive consulting firm.

It's also important to remember that forming a captive requires a long-term commitment. Shutting down a captive can be an expensive, time-consuming process. Despite the challenges, a captive can be an effective solution to a company's risk management needs, under the right circumstances. ■

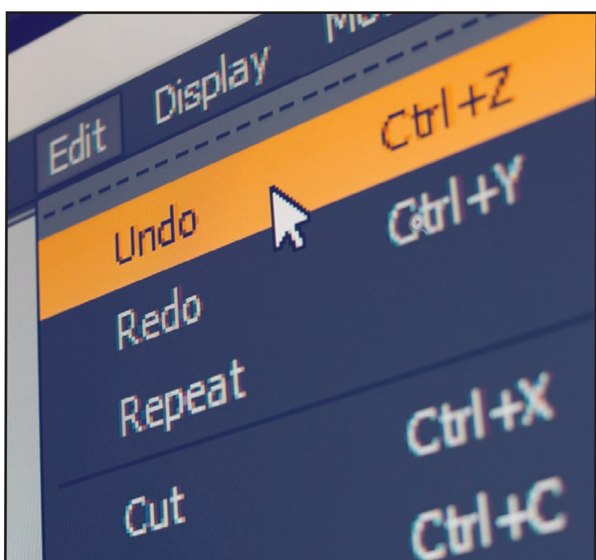
Undoing an ILIT is possible in certain situations

Owning a life insurance policy can provide peace of mind that your family's financial well-being will be taken care of after you're gone. It's generally a good idea to set up an irrevocable life insurance trust (ILIT) to hold the policy. Doing so will keep the policy's proceeds out of your taxable estate.

But what if you have an ILIT that you no longer need? Does its irrevocable nature mean you're stuck with it forever? Not necessarily. Much depends on the terms of the trust and your state's applicable law.

What's an ILIT?

An ILIT shields life insurance proceeds from estate tax because the trust, rather than the insured, owns the policy. Note, however, that under the "three-year rule," if you transfer an existing policy to an ILIT and then die within three years, the proceeds remain taxable. That's why it's preferable to have the ILIT purchase a new policy, if possible, rather than transferring an existing policy to the trust.



The key to removing the policy from your taxable estate is to relinquish all "incidents of ownership." For example, that means you're prohibited from retaining the right to do the following:

- Change beneficiaries,
- Assign, surrender or cancel the policy,
- Borrow against the policy's cash value, or
- Pledge the policy as security for a loan.

However, the trustee may be granted the power to do these things.

How do you undo an ILIT?

Generally, there are two reasons you might want to undo an ILIT. First, you might not need life insurance anymore. Second, you might still need life insurance but your estate isn't large enough to trigger estate tax, and you'd like to eliminate the restrictions and expense associated with the ILIT structure. Although your ability to undo an ILIT depends on the circumstances, potential options include:

Allowing the insurance to lapse. This may be a viable option if the ILIT holds a term life insurance policy that you no longer need (and no other assets). You simply stop making contributions to the trust to cover premium payments. Technically, the ILIT continues to exist, but once the policy lapses it owns no assets. It's possible to allow a permanent life insurance policy to lapse, but other options may be preferable, especially if the policy has a significant cash value.

Swapping the policy for cash or other assets. Many ILITs permit the grantor to retrieve a policy from an ILIT by substituting cash or other assets of equivalent value. If allowed, you may then be able

to gain access to a policy's cash value by swapping it for illiquid assets of equivalent value.

Surrendering or selling the policy. If your ILIT holds a permanent insurance policy, the trust might surrender it, which will preserve its cash value but avoid the need to continue paying premiums. Alternatively, if you're eligible, the trust could sell the policy in a life settlement transaction.

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Distributing the trust assets. Some ILITs give the trustee the discretion to distribute trust funds (including the policy's cash value, other trust assets or possibly the policy itself) to your beneficiaries, such as your spouse or children. Typically, these distributions are limited to funds needed for "health, education, maintenance and support."

Going to court. If the ILIT's terms don't permit the trustee to unwind the trust, it may be possible to obtain a court order to terminate it. For example, state law may permit a court to modify or terminate an ILIT if unanticipated circumstances require changes to achieve the trust's purposes or if the grantor and all beneficiaries consent.

These are some, but by no means all, of the strategies that may be available to unwind an ILIT.

Talk to your advisor

If you've recently reviewed your estate plan and decided that an ILIT no longer meets your needs, contact your advisor or lawyer to learn about pulling the life insurance policy out of the ILIT or even unwinding the ILIT entirely. Be sure to ask about the tax implications of taking such actions. ■

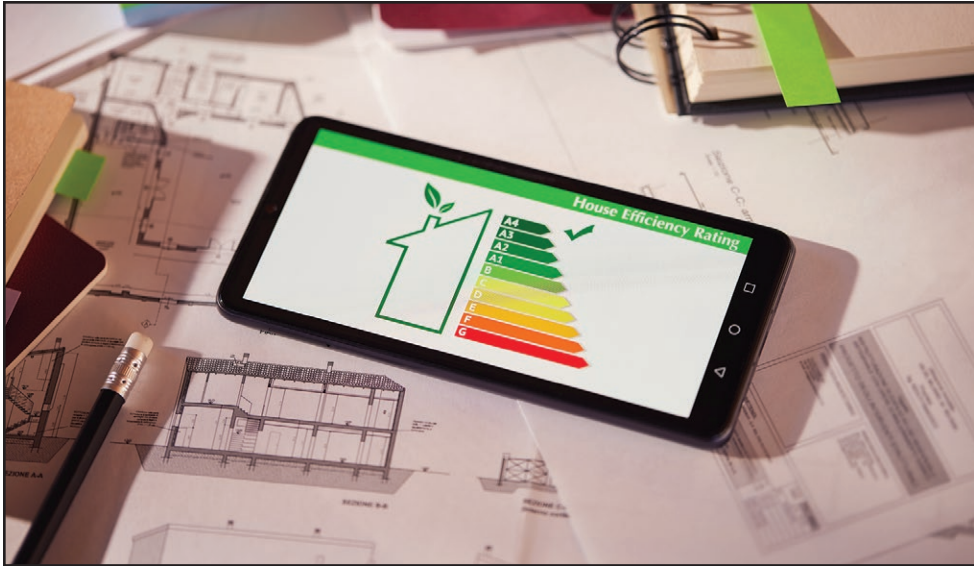
Are energy-efficient home improvement rebates taxable?

The Inflation Reduction Act (IRA) expanded several existing tax incentives — and created some new ones — for homeowners who "go green." Among the new incentives are two IRA-funded Department of Energy (DOE) programs that provide rebates to homeowners who invest in certain energy-efficient home improvement and electrification projects.

When the IRA was enacted, there was some uncertainty over how these rebates would be treated for federal income tax purposes. Fortunately, the IRS has provided some answers. In Announcement 2024-19, the IRS clarified that homeowners who receive rebates aren't required to include them in their gross income. However, they must reduce their cost basis in the property by the amount of the rebate. The IRS also explains how rebates affect the calculation of the energy-efficient home improvement credit.

What it means for homeowners

According to the IRS, home-energy rebates are treated as purchase price adjustments and,



of services to a purchaser. For example, a contractor may receive a rebate on energy-efficient property that it purchased for a residential remodeling project.

These rebate payments are includible in the business's gross income. They also may be subject to information reporting.

therefore, are excluded from gross income for federal tax purposes. However, that means the amount of the rebate isn't included in the purchaser's cost basis. A reduction in basis can potentially increase a homeowner's taxable gain when the home is sold.

Suppose, for example, that a homeowner purchases eligible energy-efficient property with a pre-rebate price of $600 and receives a point-of-sale rebate of $500. The rebate is nontaxable, but the homeowner's cost basis in the property is only $100.

What happens if the homeowner purchased the property earlier for $600 but later receives a $500 rebate? In that case, the homeowner also has to reduce his or her basis in the property from $600 to $100.

Note that rebate payments treated as purchase price adjustments aren't subject to IRS information-reporting requirements (under which payors of amounts over $600 must file information returns with the IRS and furnish statements to the payee). So, the entity paying the rebate (a state or local government, for example) isn't required to report the payment on Form 1099, even if it's more than $600.

What it means for businesses

Sometimes rebates are paid directly to a business in connection with its sale of goods or provision

Coordination with the energy-efficient home improvement credit

This tax credit, available under Internal Revenue Code Section 25C, had expired but was revived and expanded by the IRA. It allows homeowners to claim a credit of up to 30% of the cost of qualifying energy-efficiency improvements, residential energy property and home energy audits, subject to certain limits.

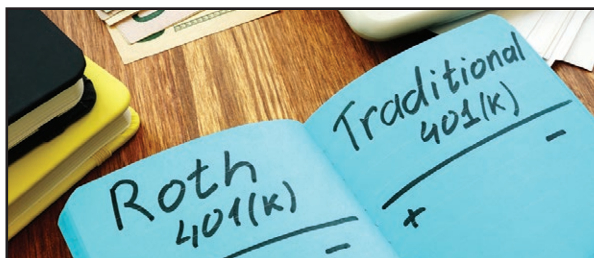
The IRS announcement clarifies that homeowners who receive rebates under one of the DOE programs *and* claim the Sec. 25C credit must reduce the amount of qualified expenditures used to calculate the credit by the amount of rebates they receive. The announcement provides an example: If a homeowner purchases an eligible product for $400 and receives a $100 rebate through one of the DOE programs, the homeowner may claim a 30% credit with respect to the remaining $300 of qualifying expenditures. In other words, the Sec. 25C credit would be reduced from $120 to $90.

Rebates coming soon

As of this writing, rebates aren't yet widely available. However, many rebate programs are expected to be launched in 2024. Be sure to monitor developments in your state. ■

Matching Roth contributions: potential pitfalls

The SECURE 2.0 Act added an option for employees who receive matching contributions from their employers to their 401(k) plans or other qualified plans. If your plan allows, you can choose to receive employer matches as after-tax Roth contributions. To avoid unpleasant surprises, however, assess the impact of such contributions on your tax bill. After-tax contributions increase your income for the year, but your employer may not automatically withhold the necessary extra taxes.



Suppose your salary is $150,000, and your employer makes matching contributions to your 401(k) account equal to 6% of your salary ($9,000). Assuming you're in the 24% tax bracket, you'd end up owing an extra $2,160 in federal income tax for the year ($9,000 x 24%) if you opt to take the employer match as a Roth contribution. Plus, you might also owe extra state income tax. To avoid underpayment penalties, consider increasing your withholdings or quarterly estimated tax payments to cover the additional tax liability. ■

Watch out for fake charities

When there's a natural disaster or other tragic event, fake charities usually appear, ready to take advantage of your generosity and compassion for those in need. The cost of donating to an illegitimate charity can be high. Not only will your intended recipients be deprived of your donations, but you also can lose valuable tax deductions. Plus, fake charities may attempt to obtain sensitive personal and financial information they can exploit to steal your identity.

Many fake charities use names that are similar to those of legitimate charities, so it's important to be diligent to avoid being duped. The IRS urges taxpayers to resist pressure tactics and take the time to vet charitable organizations before you donate. Consider using resources like the IRS's Tax-Exempt Organization Search (TEOS) tool. The IRS also advises taxpayers to avoid charities that ask for donations via gift card or wire transfer. Instead, pay by credit card or check, and don't provide your Social Security number or other unnecessary personal or financial information. ■

Are you eligible for the self-employed health insurance deduction?

If you're self-employed, you may be able to deduct 100% of the health insurance premiums you pay for you and your family. It makes no difference whether you purchase the insurance in your own name or your business purchases it. Keep in mind that the deduction can't exceed the net income you earn from your business. Also, the deduction is unavailable if you're eligible to participate in a health insurance plan subsidized by an employer of you or your spouse. ■

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