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Alaska 2017! We are in the early stages of planning our next Alaska cruise seminar. The seminar in 2015 was a truly phenomenal week, and we're eager to get back to our favorite (tax-deductible) destination of all. See the insert that we are enclosing with this Newsletter for some preliminary information.

A Captive Insurance Company, If Structured Prudently, Can be a Tremendous Tax Savings Device: We are revisiting this topic in response to several clients asking for our current thoughts. In the past, we've had a negative reaction to the notion of captive insurance companies for our practices - even though we've known that some of our clients use them. This has been an area rife for phony tax shelter promoters and insurance salesmen. Also, the IRS is monitoring captives for small businesses and sees it as an area for potential abuse. A good summary can be found in the recent New York Times article "IRS is Looking Into Captive Insurance Shelters" which can be easily found online.

After speaking with some people in this industry, our opinion is softening. The IRS has approved some small business captives, though these are cases where the advisors are legitimate and take the legal requirements seriously.

A captive is a special insurance business that is wholly owned by a related party. This could be you, your practice, a family limited partnership, etc. The business (i.e., your practice) then pays insurance premiums to the captive in exchange for the captive insuring certain risks of that business. The parent may use traditional insurers to cover certain basic business risks like property, casualty, fire, flood, etc., but the captive will cover other ones for which the parent is uninsured.

If this is a real insurance business, then under tax code section 831(b), up to $1,200,000 of annual insurance premiums paid to the captive are tax-deductible to the parent and tax-free to the captive. (Credit the powerful insurance industry lobby for this favorable tax treatment.) Then, after a relatively short amount of time with few (or no) claims made on the captive, the premiums that were being held in reserve to pay claims are considered to be insurance company profits which can be withdrawn as dividend payments to the owner. The dividends will be taxed at the lower dividend rates, not the higher ordinary income rates.

With That as the Background, Here is How a Captive is Formed: A lawyer or CPA will use insurance actuaries to examine your practice, seeing what insurance you have in place, what risks are not insured, and what could be covered by the captive. They will prepare a report describing their findings and estimating what the premiums would be if the captive provides the insurance.

This feasibility is an important first step. It determines whether a captive will make sense for your practice. A law firm then forms the captive, typically in a foreign jurisdiction like the Bahamas or Bermuda. These are less costly to operate in and the insurance climate is friendlier. But other than incorporating in a foreign country, there is little connection to that jurisdiction. For example, the captive will have an investment account in the U.S. where you or your advisor will invest the insurance premiums.

For this whole arrangement to be legitimate, the captive must be a real insurance company. Under our judicial system, insurance consists of two activities - (1) risk shifting, and (2) risk distribution. Risk shifting is easier to show. The captive receives premiums, and in return, it is contractually required to pay insurance benefits. The risks have been shifted.

Risk distribution means that an insurance company is bundling the risks of one business with those of many other businesses to protect against the possibility that one company's risks might bankrupt the insurer. Risk distribution is much harder to show, and it is why the IRS has been able to successfully attack some captives. This will require your captive to enter into a risk distribution agreement with at least a dozen other captives. Your captive will receive premiums from the other members of the group, and your captive will pay some premiums to them.

The captive manager (a specialized and hopefully reputable company selected by your lawyer) will handle these details, and ideally have your captive enter a risk sharing pool with other low-risk businesses. The goal is for there to be very few claims made on the captives so that the premiums will eventually get passed out to the captive owner as capital gains.

There will be assorted annual compliance work for which the captive manager will be responsible, including reporting to the insurance regulators of your home jurisdiction, tax filings in the foreign jurisdiction and possibly the U.S.

Who Is a Candidate for a Captive Insurance Company? You might consider this only if you are a high earning doctor who is already maximizing contributions to a defined benefit plan. The start-up and maintenance costs are expensive enough that you shouldn't consider a captive unless you have **at least** $250,000 of additional practice income that you can afford to live without.

What Are the Costs? What Are the Risks? Assume the first-year start-up costs will be $60,000 to $90,000. This will include a comprehensive review of your practice and its insurance coverages, an insurance proposal for your captive, the incorporation, working with the local insurance regulators, entering your captive into a risk pool, etc. So, if the annual captive premiums are $300,000, the first year cost may be 30%. This is far less than the combined taxes you would pay to Uncle Sam and your home state if you didn't create the captive. After the first year, the annual maintenance costs are approximately 10% of the annual premiums paid to the captive.

An obvious risk is that you have a captive that doesn't pass muster. There are two major areas we see potential for problems: (1) there is not enough risk distribution, and (2) the captive is insuring for risks that aren't reasonable and/or that are dramatically overpriced based on the low probabilities of them happening. Questionable risks include terrorism, kidnap and ransom, and hurricane insurance for companies located far from the coasts. More legitimate ones would be business interruption insurance, disability, and employment practices liability insurance.

Another risk is working with the wrong people. Don't use a captive manager that isn't up front about the costs, benefits and risks or who sells life insurance as a captive "investment." Vet the lawyer or CPA who oversees the transaction. Find out how many of their captives have been investigated by the IRS, and how many of them have held up to IRS scrutiny. They will likely have several. If they say that captives are a tax panacea, you may be dealing with a charlatan who plays fast and loose with the strict regulations. Ask for and get recommendations from some of their ongoing doctor clients who've set up captives with them - preferably people who have had them for at least three years. These people will have had captives long enough to understand how they operate.

Final Caveat: We have not set up a captive for ourselves and we currently don't offer this as a client service. However, we can see that with a good captive manager who carefully plans and maintains the captive, this can be a big tax savings opportunity.

The IRS Gets Hacked: The IRS announced that it was hacked in a sophisticated operation that resulted in the theft of sensitive tax information of 104,000 individuals. The thieves used previously stolen social security numbers to hack into the IRS's "Get Transcript" tool which allows taxpayers to pull up previously filed tax returns. They used the information to file phony 2014 returns on behalf of these people and claim millions in refunds. In short, these victims have already had their Social Security numbers stolen, and now they have their old tax returns stolen.

The IRS is notifying the victims and informing them what information has been compromised, and it will pay the small cost of credit monitoring for these 104,000 people. This is cold comfort. If a phony tax return has been filed under your name, call your CPA immediately. They've likely had to deal with this for other clients and can initiate the clean-up process. The honest taxpayers will eventually get their refunds, but this will be a mess to clean up, because you've still had your Social Security number stolen. The Federal Trade Commission website www.consumer.ftc.gov/features/feature-0014-identity-theft is an excellent guide for the steps you should take after becoming a victim of identity theft. Rather than repeating what's on the website, we recommend you go there directly.

You can't guarantee against identity theft, unless you are covered by an identity theft insurance policy. No matter how careful you are in guarding your Social Security number, there are times you can't avoid giving it out, such as at filling out new account information or filling out loan paperwork. There can be rogue employees within these organizations that will sell large batches of private client information to the identity thieves.

Protecting Against Identity Theft:

1. Do not provide your Social Security number when it is not required. Many organizations use your Social Security number as a unique identifier (doctor's offices, hospitals, schools, charity organizations, etc). Just because someone asks for it, doesn't always mean you have to comply.

2. Do not keep your personal records in the office. Your home is the safest place for your Social Security number, medical records, driver license, and other personal information. All records that contain your personal information should be shredded.

3. Establish fraud alerts with Equifax, Experian and TransUnion. These require potential credit grantors to verify more of your personal identification before credit information is released. Request this with one, and it will notify the others. Experian's registration website is www.experian.com/fraud/center.html. This must be renewed every 90 days, so mark your calendar.

4. Be removed from pre-approved credit cards, insurance policies and other junk mail. These mailings can be intercepted and

personal data stolen. Opt-out here: www.optoutprescreen.com/?rf=t.

5. Order your free credit reports to see all of your open credit accounts and possible detection of identity theft. We are entitled to one free report from each credit bureau for year. Www.annualcreditreport.com is a government-run website and is the only free alternative for this. Spread out your request during the year in order to get rotating continuous updates. We have marked our calendars so that every four months we order the next one (January 1st is Equifax, May 1st is Experian and September 1st is TransUnion).

6. If you are forgetful by nature, then pay $10 per month for LifeLock (you've likely heard their radio ads) and it will do all of the above. (LifeLock also claims a $1,000,000 guarantee if your identity or money is stolen, but the limitations and fine print really render this "guarantee" meaningless.)

7. Never save/store passwords in your web browser for ease of logging into sites. Also, log off of financial websites before leaving the site or turning off your computer.

8. Use good antivirus and anti-malware programs. Our IT firm likes Microsoft's free program called Security Essentials, but also recommends either TrendMicro (for anti-virus and anti-malware) and Malwarebytes (specifically for malware) for those who want to feel more secure.

What if the Fed Does Raise Interest Rates Later this Year? Financial advisors and the media are predicting that the Federal Reserve will start raising short-term interest rates this coming fall. If interest rates go up, the concern is that asset prices will fall. Stocks will look less attractive compared to bonds that are now paying higher rates. Real estate prices will fall because borrowing costs are going up.

The small rate increases should have a negligible impact, particularly on stock prices. When the yield on the 10-year U.S. Treasury bond has been in the 2%-3% range, the stock market, as measured by the S&P 500 index, has had a price-to-earnings (P/E) ratio of 17.9. When the yield has been in the 3%-4% range, the stock market P/E has been even higher, at 18.7. With the yield at 4%-5%, the stock market P/E has been 17.4. But, when the 10-year government bond yields 6%, the stock market will indeed drop. So, rates can increase significantly before stock prices plummet. The news about incrementally rising rates is more bark than bite.

To put things in perspective, the current yield on the 10-year bond is 2.4%, and the P/E ratio for the S&P 500 is 20.3. If the yield goes into 3%-4% territory and the market drops to a P/E of 18.7, that could translate into a 9.2% drop - which will be good news for long term investors looking to buy shares at great entry points.

Correction: In the last issue we said that we would like to buy shares of the pharmaceutical company Novartis on the next stock market dip. Novartis's ticker symbol is NVS, not NOV.

Declining ADA-Tripartite Membership: The percentage of practicing dentists who are ADA members is 64.5%, down from 69.1% five years ago. The declining trend impacts the national, state and local levels. It used to be that new graduates would join the ADA as a matter of course. Now membership is an economic decision. The millennial generation is concerned about getting value for their dollars, especially with their big student debts.

As for value, there are many individual benefits that by themselves are worth the cost of membership, including the group insurance policies and the analysis of dental benefit plans. But the biggest benefit (that all dentists receive whether or not they pay dues) is that the ADA (and state and local associations) is the main political advocate for the dental profession. It lobbies for dentists in Congress, in state legislatures, and from time to time in court against unfair insurance tactics and unnecessary government regulation. Without a strong ADA, dentistry risks going the way of medicine, eventually resembling little more than a government run service industry.