IRS INVESTIGATIONS & PRACTICES
SUBCOMMITTEE REPORT

American Bar Association
Tax Section Meeting, May 10, 2019

Eric L. Green
Green & Sklarz, LLC
700 State Street, Suite 100
New Haven, CT 06511
P. (203) 285-8545
egreen@gs-lawfirm.com
I. The End of “Captive Insurance Companies” as a Planning Technique.

The IRS assault on captive insurance companies is almost complete. Through audits, litigation, published guidance, and legislation, the IRS continues to address these arrangements that it views as little more than a tax shelter and a scam.

The law generally allows businesses to create “captive” insurance companies to protect against certain risks. Traditional captive insurance typically allows a taxpayer to reduce insurance costs. The business can claim the deduction for the premiums it pays for insurance policies. Here the difference is the business itself or others related to the business owns the insurance company that it is paying its premiums to, hence the “captive” aspect of the insurance company.

IRC § 831(b) of the tax code allow those captive insurers that qualify as small insurance companies to exclude limited amounts of annual net premiums from income so that the captive insurer pays tax only on its investment income. The IRS views this is a shelter because in certain “micro-captive” structures, promoters, accountants or wealth planners persuade owners of closely-held entities to participate in schemes that lack many of the attributes of genuine insurance. For instance:

- coverages may insure implausible risks;
- coverages fail to match genuine business needs;
- coverage may duplicate the taxpayer’s commercial coverages;
- premium amounts may be unsupported by underwriting or actuarial analysis,
- premiums may be geared to a desired deduction amount or may be significantly higher than premiums for comparable commercial coverage;
- policies may contain vague, ambiguous or deceptive terms and otherwise fail to meet industry or regulatory standards;
- claims’ administrative processes may be insufficient or altogether absent;
- insureds may fail to file claims that are seemingly covered by the captive insurance.

In addition to the above, which create the situation where the “captive” is truly not acting like a commercial insurer would, the captive may invest in illiquid or speculative assets or loans or otherwise transfer capital to or for the benefit of the insured, the captive’s owners or other related persons or entities.

Captives may also be formed to advance inter-generational wealth transfer objectives and avoid estate and gift taxes. Promoters, reinsurers, and captive insurance managers may share common ownership interests that result in conflicts of interest.

Recent cases reflect a growing disquiet with these structures:

In Avrahami v. Commissioner, the U.S. Tax Court disallowed premium deductions the taxpayer had claimed under a section 831(b) micro-captive arrangement, concluding that the arrangement was not “insurance” under long established decisional law principles. To qualify as insurance under those principles, an arrangement must involve risk shifting, risk distribution and insurance risk, and must also meet commonly accepted notions of insurance. The Avrahami court
concluded that the taxpayer’s arrangement failed to distribute risk and that the taxpayer’s captive was not a bona fide insurance company. The court pointed to a number of facts that it found problematic, including circular flows of funds, grossly excessive premiums, non-arm’s length contracts, and an ultra-low probability of claims being paid. The court also concluded that the arrangement was not insurance in the commonly accepted sense, due in part to haphazard organization and operation, the captive’s investments in illiquid assets, unclear policies, and inflated premiums.

In Notice 2016-66 (Nov. 1, 2016), the IRS advised that micro-captive insurance transactions have the potential for tax avoidance or evasion. The notice designated transactions that are the same as or substantially similar to transactions that are described in the notice as “Transactions of Interest.” The notice established reporting requirements for those entering into such transactions on or after November 2, 2006, and created disclosure and list maintenance obligations for material advisors.

Separately, Congress has also acted to curb micro-captive abuses. The Protecting Americans from Tax Hikes (PATH) Act, effective January 1, 2017, established strict diversification and reporting requirements for new and existing captives.

Captive insurance companies have since been added to the IRS list of “Dirty Dozen Tax Scams”

II. **New IRS Voluntary Disclosure Pre-Clearance Form released by the IRS April 11, 2019**

III. **U.S. Attorney Announces The Arrest Of Michael Avenatti For Engaging In A Scheme To Extort A Public Company**

On Monday, March 25, 2019 the United States Attorney’s Office in the Southern District of New York announced the arrest of Michael Avenatti on federal extortion and interstate threat charges. As alleged, Mr. Avenatti, an attorney, attempted to extract more than $20 million in payments from Nike, a publicly traded company by threatening to use his ability to garner publicity to inflict substantial financial and reputational harm on the company if his demands were not met.

It is also worth noting that Mr. Avenatti was simultaneously arrested on separate charges brought by the U.S. Attorney’s Office for the Central District of California.

“As alleged, Avenatti used illegal and extortionate threats for the purpose of obtaining millions of dollars in payments from a public company. Calling this anticipated payout a retainer or a settlement doesn’t change what it was—a shakedown. When lawyers use their law licenses as weapons, as a guise to extort payments for themselves, they are no longer acting as attorneys. They are acting as criminals, and they will held responsible for their conduct.”

FBI Assistant Director in Charge William F. Sweeney Jr. said: “As alleged, Michael Avenatti approached Nike last week with a list of financial demands in exchange for covering up allegations of misconduct on behalf of the company. The lofty price tag included a $1.5 million payoff for Avenatti’s client and upwards of tens of millions of dollars for the legal services of his firm—services Nike never requested. This is nothing more than a straightforward case of extortion. In the event anyone needs to be reminded, this type of behavior is illegal and it will not
be tolerated—especially when committed by a lawyer who is supposed to use his license to practice law, not to willfully violate it.”

According to the allegations in the Complaint unsealed in March:

In a scheme that unfolded in less than a week, Mr. Avenatti and a co-conspirator not named as a defendant in the Complaint used threats of economic and reputational harm to extort Nike, a multinational corporation engaged in, among other things, the marketing and sale of athletic apparel, footwear, and equipment. Specifically, Avenatti threatened to hold a press conference on the eve of Nike’s quarterly earnings call and the start of the annual National Collegiate Athletic Association (“NCAA”) men’s basketball tournament at which he would announce allegations of misconduct by employees of Nike. Avenatti stated that he would refrain from holding the press conference and harming Nike only if Nike made a payment of $1.5 million to a client of Avenatti’s in possession of information damaging to Nike (“Client-1), and further agreed to “retain” Avenatti and his client to conduct an “internal investigation”—an investigation that Nike did not request—for which Avenatti and his client demanded to be paid, at a minimum, between $15 and $25 million. Alternatively, and in lieu of such a retainer agreement, Avenatti and his client demanded a total payment of $22.5 million from Nike to resolve any claims the client might have and additionally to buy Avenatti’s silence.

Mr. Avenatti, 48, of Los Angeles, California, is charged with one count of conspiracy to transmit interstate communications with intent to extort, which carries a maximum penalty of five years in prison, one count of conspiracy to commit extortion, which carries a maximum penalty of 20 years in prison, one count of transmission of interstate communications with intent to extort, which carries a maximum penalty of two years in prison, and one count of extortion, which carries a maximum penalty of 20 years in prison. The maximum potential sentences in this case are prescribed by Congress and are provided here for informational purposes only, as any sentencing of the defendant will be determined by the judge.

IV. IRS and Dept. of Justice Continue to Focus on Dirty Tax Preparers

The Justice Department’s Tax Division, in collaboration with U.S. Attorney’s Offices, takes legal action throughout the United States, including seeking court orders to shut down tax return preparers who prepared false tax returns, and criminally prosecuting fraudulent tax return preparers to punish dishonest tax return preparers for their fraudulent activities and to protect taxpayers and government funds.

During this tax season, examples of some of the criminal convictions obtained by the Tax Division include:

- On March 7, 2019, a Miami, Florida, Certified Public Accountant (CPA) was sentenced to 39 months in prison for tax evasion. Darryl Sharpton willfully evaded the payment of federal income taxes for the tax years 2004 through 2008 and 2010. He was ordered to pay $1,380,602 in restitution to the IRS.
- On March 20, 2019, a Charlotte, North Carolina, tax return preparer was sentenced to 24 months in prison for preparing income tax returns for clients that claimed false
deductions and fictitious businesses in order to obtain the Earned Income Credit. Shawanda Elmore prepared approximately 500 fraudulent tax returns.

- On March 4, 2019, a federal jury convicted a New York owner of a tax return preparation business for conspiring to commit aggravated identity theft and aiding and assisting in the preparation of false tax returns. Afolabi Ajelero used the identity of others to accomplish the scheme. His co-defendant, Hakeem Bamgbala, also has been convicted and awaits sentencing on wire fraud, aggravated identity theft, and aiding and assisting in the preparation of a false tax return charges.
- On February 8, 2019, a Hattiesburg, Mississippi, CPA was convicted of conspiracy to defraud the United States, aiding in the preparation of false tax returns and filing false tax returns. Carl Nicholson was also found guilty of filing his own false personal income tax returns for 2012 through 2015. He faces sentencing on May 23, 2019.

Examples of some of this tax season’s civil injunctions obtained by the Tax Division include:

- On March 29, 2019, a federal court in Dallas, Texas, permanently enjoined Jhane Broadway, individually and doing business as Jeprofessionalz or MaxTaxPros, from preparing federal income tax returns for others. Broadway was required to mail or e-mail notice of the injunction order to all customers for whom she prepared a federal tax return or claim for refund for tax years 2015 through 2017.
- Also on March 29, 2019, a federal court in Beaumont, Texas, entered a permanent injunction against tax return preparer Sylvia Rodriguez, who is also known as Sylvia Omelas, barring her from preparing federal tax returns for others and owning or operating a tax preparation business. The court found that Rodriguez engaged in fraudulent and deceptive conduct that substantially interfered with the administration of the tax laws.
- On March 27, 2019, a federal court in Miami, Florida, entered a permanent injunction barring Vilbrun Simon, Saintanise Agenord, Simon Accounting & Tax Services LLC, and Village Tax Multi Services from preparing federal income tax returns for others. The group is prohibited from operating, managing, or participating in any business, which prepares tax returns.

V. Federal Court in North Carolina Authorized Service of John Doe Summonses Seeking Information About Finnish Residents Using Bank of America, Charles Schwab, and TD Bank Payment Cards Linked to Non-Finnish Bank Accounts

A federal court in North Carolina authorized the Internal Revenue Service (IRS) to serve John Doe summonses on Bank of America, Charles Schwab, and TD Bank in an order that was unsealed yesterday, the Justice Department announced. The John Doe summonses seek information about persons residing in Finland that have Bank of America, Charles Schwab, or TD Bank payment cards linked to bank accounts located outside of Finland. The summonses are referred to as “John Doe” summonses because the IRS does not know the identity of the persons being investigated.