IRS INVESTIGATIONS & PRACTICES
SUBCOMMITTEE REPORT

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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 Jan. 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”


IRS Criminal Investigations celebrated its 100 year in 2019, and this year’s report reviewed the history of IRS-CI, reviewing the highlights from each decade. The updated statistics released for 2019 include:

**Tax Crimes:**
- 1,500 investigations initiated
- 942 Prosecutions recommended
- 848 Sentenced

**Non-Tax Crimes (Money Laundering, Bank Secrecy Act violations, Public Corruption, Fraud):**
- 985 Investigations Initiated
- 951 Prosecutions Recommended
- 878 Sentenced
III. \textit{SB/SE is committed to having its Field Force making enforcement sweeps in areas currently underserved}

Both IRS Commissioner Charles Rettig and SB/SE Commissioner Eric Hylton have stated that we can expect to see the IRS making enforcement sweeps in those geographic areas that are currently not being focused on by the IRS. These will include appointments made in advance and drop-by meetings by IRS personnel, who will set up shop in these areas for several days at a time, with the goal to increase taxpayer compliance.

IV. \textit{IRS Collection Division making greater use of “Disqualified Employment Tax Levies”}

The IRS may seize, or levy assets of a taxpayer once that taxpayer has a tax balance assessed and has received notice under IRC § 6330. The notice allows the taxpayer to request a Collection Due Process (“CDP”) hearing with the IRS Appeals Division prior to any action being taken by the IRS Collection Division.

There are several exceptions to the rule to wait 30-days to see if the taxpayer requests a hearing, and one of those exceptions is for unpaid payroll taxes. IRC § 6330(f)(3) states that the IRS does not need to allow the taxpayer time to file for a CDP request and move to seize immediately if the Secretary has served a disqualified employment tax levy. IRC § 6330(h) defines a “disqualified employment tax levy” as:

\begin{quote}
A disqualified employment tax levy is any levy in connection with the collection of employment taxes for any taxable period if the person subject to the levy (or any predecessor thereof) requested a hearing under this section with respect to unpaid employment taxes arising in the most recent 2-year period before the beginning of the taxable period with respect to which the levy is served. For purposes of the preceding sentence, the term “employment taxes” means any taxes under chapter 21, 22, 23, or 24.
\end{quote}

What this means for taxpayers who are struggling with payroll taxes is that once they have had a CDP hearing, that if they incur another payroll tax debt within two-years that the IRS will move immediately to seize money, so that the taxpayer cannot count on having a CDP hearing to forestall collection efforts.