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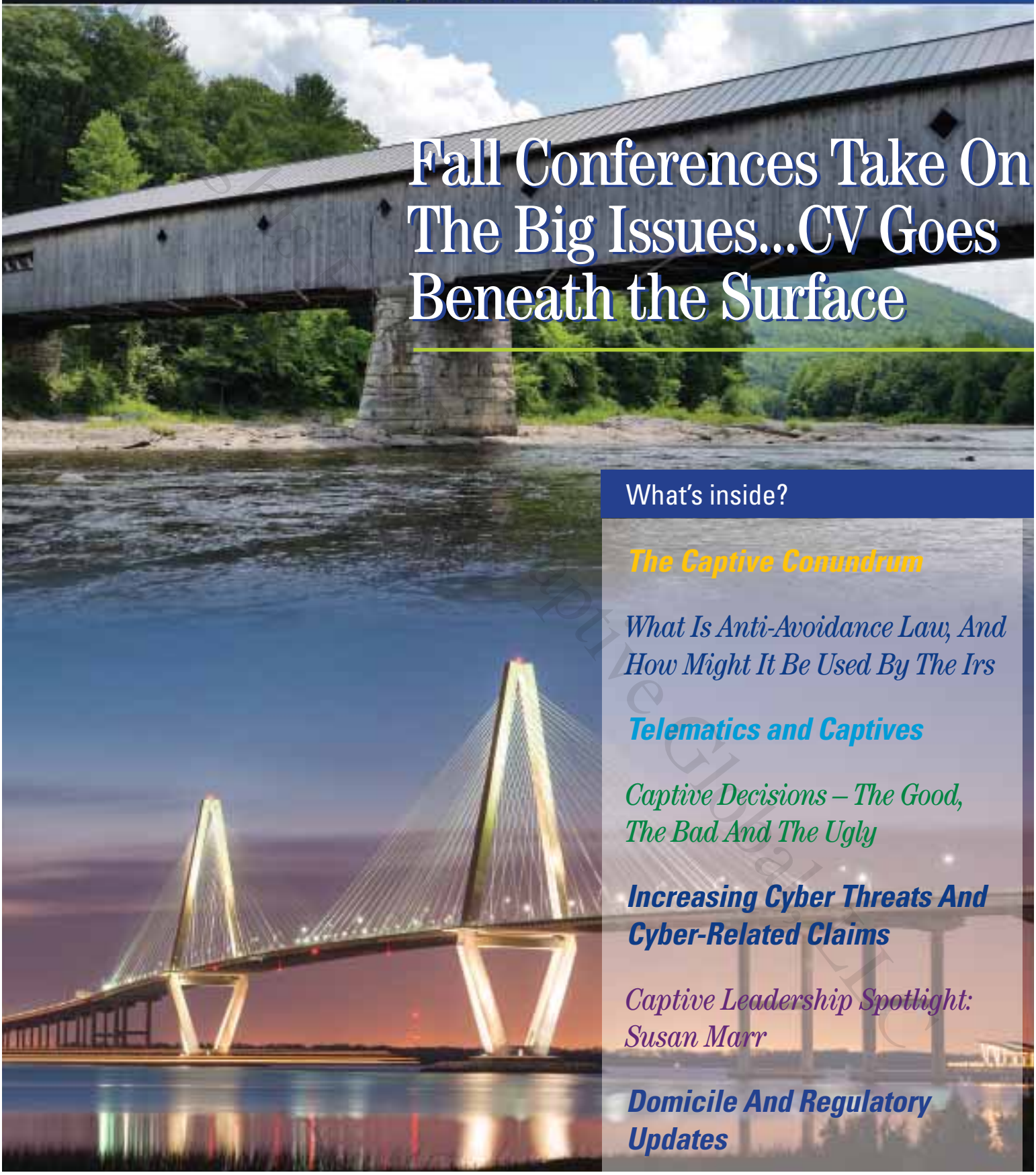
Explore the ART of Captives Beneath The Surface



Fall Conferences Take On The Big Issues...CV Goes Beneath the Surface

What's inside?

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Cover art: Top photo in cover collage shows the West Dummerston Covered Bridge, taken in 2014 by Steve Chagno from Innertek Software. This is the second longest covered wooden highway bridge wholly within the state of Vermont, and the longest covered bridge still open to traffic. Constructed in 1872 by Caleb B. Lamson, a locally prominent bridge builder, the West Dummerston bridge is the only known example of his work to survive.

Bottom photo in collage is South Carolina's Arthur Ravenel Bridge.

What Is Anti-Avoidance Law, And How Might It Be Used By The IRS To Challenge Aggressive Captive Transactions?

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The vast majority of captive insurance companies electing under IRC § 831(b) are likely tax compliant insurance companies that the Internal Revenue Service ("IRS") would not challenge on tax avoidance grounds. That being said, the IRS is clearly going to be troubled by the more aggressive practices of a minority of IRC § 831(b) captives, some of which have previously been discussed in this series of articles. The IRS has a number of different tax avoidance weapons available to utilize in formulating a challenge to tax-related financial transactions, including certain activities of § 831(b) captives. Over the next few articles in this series, we will provide an overview of a few of these weapons, and provide examples of how they may be used by the IRS in specific captive circumstances. This article will begin this discussion by focusing on two primary questions: what is anti-avoidance law, and why should a captive professional care about it.

What is anti-avoidance law?

While no universally accepted definition of anti-avoidance law exists, it can generally be

doctrines created to prevent practitioners from bastardizing Congressional intent with respect to the Internal Revenue Code ("IRC"). For example, insurance premiums can be deducted under 26 U.S.C. 162(a) as an "ordinary and necessary" business expenses. Simply complying with the statutory language is fairly easy; a taxpayer simply needs to demonstrate that money was expended and that it did so in the ordinary course of business. For example, it is likely satisfactory evidence that an accounting entry or bank record shows money left the company's account and went to an insurance company. Put in anti-avoidance parlance, we can readily establish compliance with the statute's "form." However technically easy it seems to comply with such a broadly written statute, a taxpayer still needs to look further than the IRC language to understand what is and isn't allowed.

The accompanying treasury regulations for 26 U.S.C. 162(a) provide further guidance by specifically mentioning insurance premiums as a deductible item. But the definition of insurance contained in the regulations is incomplete

"insurance" with no further explanation. Accompanying case law provides the necessary guidance by explaining insurance is comprised of a five elements: definite risk; an insurable interest; fortuity; risk shifting; and risk distribution. By developing a deeper understanding of the term "insurance," and aligning the transaction elements with the underlying nuances expressed in case law, we can create legal "substance" such that the IRS will recognize the transaction as valid.

Anti-avoidance law is concerned with far more than mere technical compliance with the terms expressed in a

facts and circumstances must comport with legally understood substance concepts such as the above-mentioned five elements of insurance. The taxpayer's actions must actually evidence that the transaction was substantively in keeping with what Congress intended in the statute. For example, rather than demonstrating that the transaction originated from organic business needs, communications between the taxpayer and a promoter that focus predominately or exclusively on the tax benefits of a transaction may indicate that the taxpayer's motivations were not in keeping with Congressional intent for permitting the deduction. Other potential bad facts could be the business entity holding no meetings, or has significantly incomplete corporate paperwork. The number of facts and circumstances that are potential indicators that a transaction lacks substance are numerous, and such bad facts give the IRS the opportunity to seek to look through the paper form of the transaction to its substance.

Five Anti-Avoidance Doctrines: The Historical Overview

There are at least five specific anti-avoidance doctrines: substance over form; sham transaction; business purpose; economic substance; and step transaction. Unfortunately, courts have been less than judicious in their use of terminology, often using terms interchangeably (especially when dealing with either the sham transaction or the economic substance doctrine), creating a fair amount of confusion among the judiciary and practitioners. Perhaps the best way to conceptualize these five doctrines is chronologically by noting the period when the most prominent cases of each doctrine were issued.

1. ***Substance over form:*** the mid-1930s to the mid 1950s. See Gregory v. Helvering, 293 U.S. 465 and Commissioner v. Court Holding, 324 U.S. 331 (1945).

2. ***The sham transaction doctrine:*** the late 1950s to the late 1970s/early 1980s. See Knetsch v U.S., 364 U.S. 361 (1960).

3. ***The business purpose doctrine:*** the late 1960s to the early 1970s. See Frank Lyon Co. v U.S., 435 U.S. 561 1978).

4. *The economic substance doctrine:* the tax shelter cases of the 1990s.

5. ***The step transaction doctrine:*** really not confined to a period.

The next article will begin a more detailed discussion of these doctrines and how they may apply to certain IRC § 831(b) captive transactions. However, before that discussion begins, it is important to understand how a captive transaction may arise from the pool of potential auditable transactions and end up facing these more advanced IRS tools.

Why should a captive professional care about anti-avoidance law?

All business transactions that have a potential tax benefit give the IRS the opportunity to audit and seek to reduce or eliminate its tax results.

Of course, the IRS does not do this in a great deal of transactions, but the more substantial the tax benefit, and the more widely used the transaction, the more likely it is that the IRS will specifically target a given transaction itself, the result of which will be a broad group of taxpayers being subject to audit. Generally, an IRS challenge to a specific taxpayer is a one-off thing. The taxpayer's return is picked up for audit by the mysterious computer formula the IRS has created for deeming a specific taxpayer's return is likely to lead to a tax adjustment. However, there are also audits that a product of another system created by the IRS to combat organized tax transactions.

Every so often an IRS auditor reviews a return that does not quite fit the audit guidelines provided to him or her, or seems to involve issues that the auditor believes are better reviewed by a more sophisticated IRS professional. If there are enough such similar cases that arise through the auditor ranks, they may be referred on to the Office of Tax Shelter Analysis ("OTSA") for collection and analysis. There are other ways that specific files can end up at OTSA as well. As the name indicates, OTSA is an internal IRS group that specializes in organized and sometimes sophisticated

transactions that the IRS may want to deem abusive, and therefore may start the process of triggering a broad-based hunt for these cases, the promoters of these cases, and the creation of an IRS position on how to attack these transactions.

As a consequence of an OTSA review, the IRS may subsequently take any number of steps. Often, a specialized forensic auditor is dispatched to do very detailed and thorough examination of a sampling of seemingly similar cases the IRS has under audit. This work of these specialists may reveal features of a transaction, common promoters or advisors involved in the transaction, and other information that allows the IRS to properly understand the organization of the tax arrangement.

The next likely step is to open promoter investigations of common professionals that appear to be organizing the transactions. These investigations lead to list maintenance letters being sent out to those under investigation to provide a list of the taxpayers who have utilized the transaction with them. The IRS likely will also send out detailed requests for information and documents.

In the IRS "Hot Seat"

Based on what the IRS finds, it may label the transaction as a "transaction of interest" or a "listed transaction". The consequences of such designation are that the participants of the transaction must file a specific IRS disclosure, or face very high penalties. Of course, even if one of these two designations, the taxpayers are not out of the hot seat. Typically, the IRS makes use of the names gathered through the requested promoter lists and audits each of them. In addition, these audits are much more detailed and the IRS is much better prepared to combat the type of transaction than if the audit simply was in front of a typical first line auditor. Of course, some of these cases invariably end up with criminal referrals to the Criminal Investigation Division ("CID"). In recent years, the last organizational step is the issuance of a Revenue Ruling or other guidance that lays out the new IRS position on specific transactions, and what makes specifically described transactions compliant, not compliant, and perhaps criminal.

In the area of IRC § 831(b) captives, the IRS appears to be nearing the tipping point of challenging certain tax transactions in a broad based manner. With the IRS having taken some of the steps discussed above, it appears we have reached a critical point in the process. The tax litigation community has been aware of forensic auditors being brought into captive cases across the U.S. for at least five years. There have been promoter investigations opened and list maintenance letters sent out going back at least four years. There have been criminal referrals made, and criminal warrants issued over the last year. Thus, the IRS appears to be gathering up information on taxpayers and advisors, and the civil/criminal line should be drawn. If the IRS pattern is followed -- and it is very rare that it is not followed once it gets this far -- there will be numerous aggressive taxpayers who will need to defend their captives against a well-organized and less than open minded IRS. The tools the IRS will use in these cases are based in anti-avoidance law. As such, it is important for captive practitioners who may have some of these taxpayers as clients to become aware of how anti-avoidance law may be used as a weapon by the IRS.

Conclusion

Going forward, this series will look at each of the above five anti-avoidance law doctrines, briefly explain its main tenets through one or two fact patterns derived from cases, and then apply those elements to standard captive insurance fact patterns.

This article is one in a series on IRS tax shelter issues dealing with captive insurance companies.

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