

IRS 831(b) ENFORCEMENT

BECKETT G. CANTLEY

Atlanta's John Marshall Law School &
Atlanta Law Group

[#ACIInsurance](#)



IRS Judicial Weapons: Anti-Avoidance Rules

- **Substance over form**
- Business Purpose
- The Sham Transaction
- **Economic Substance**
- The Step Transaction



Substance Over Form

- The facts that make up the transaction is its “form”.
- The “substance” of the transaction is what is actually below the surface of the facts, sometimes where such facts are created solely for such substance.
- This doctrine disregards the form in favor of the true substance to disallow the tax benefits generated by the artificial nature of the transaction.



IRC 831(b) Example

- IRC 162 deduction for ordinary & necessary expenses, potentially including insurance.
- Assume a risk pool is used to create the insurance, & risk is being kidnapped.
- An oil and gas executive who spends 6 mos in Nigeria needs a kidnapping & ransom policy. A dentist in Boulder, Colorado does not.
- The form is the risk pool, the substance is an unnecessary expense creating a deduction.



The Economic Substance Doctrine

Now Codified

- Prong 1: The transaction is rationally related to a **plausible non-tax business purpose**
- Prong 2: The transaction results in a meaningful and appreciable **enhancement in the net economic position** of the taxpayer other than to reduce tax.
- Code: penalties as high as 75% and there is no way to use a tax opinion to use “reasonable cause” as a defense.



IRC 831(b) Example

Loan Backs

- Insured deducts premium paid to CIC. The insured (or its owner) immediately borrows significant funds back out without paying taxes on the money.
- Rev. Rul. 2002-89, the IRS Manual, and case law indicate such CIC loan backs are at least subject to strict scrutiny, and may be prohibited under certain circumstances.
- The IRS has asked for comments on the facts & circumstances that would give rise to loan back determinations.
- This issue has come up as a **focus in audits**.
- IRS may challenge as an **improper tax-free distribution**.



IRC 831(b) Example

Loan Backs

- **Prong One:** Hard to argue that the transaction is rationally related to a useful non-tax business purpose. **If you needed the money** enough to have it loaned out shortly after paying it, **why did you make the premium payment to start with other than to get the tax deduction?**



IRC 831(b) Example

Loan Backs (4 of 4)

- **Prong Two:** Transaction appears that there is **no meaningful enhancement** in the **net economic position** of the taxpayer other than to reduce tax. Your **position is identical** before and after the transaction with respect to the loaned funds. The **only difference is that you have deducted the premium.**



IRS Statutory Weapons

- Listed Transaction Designation
- Transaction of Interest Designation
- Promoter Investigations
- List Maintenance Requests
- Criminal Investigations



Listed Transaction Designation

- IRS can designate a transaction as “listed” and trigger reporting requirements and potentially severe penalties for taxpayers and advisors.
- IRS rarely does this, so it is usually reserved for transactions that are done across the US among numerous taxpayers.
- IRS states its position in the listing notice, and judiciary has taken this designation seriously.



IRC 831(b) Example

- In early 2000's IRS designated a captive variant structure as a listed transaction.
- The IRS eventually withdrew the listing on a go forward basis, apparently in part because the deal was not widespread enough.
- Given the popularity of 831(b) captives, and the promoter exams that are ongoing, it seems like only a matter of time until something becomes a listed transaction.



Transaction of Interest Designation

- IRS can put a transaction with certain attributes on a sort of “watch list” where the IRS thinks the transaction is abusive, but is not ready to “list” the transaction permanently.
- Transactions of interest have similar reporting and penalty attributes to listed transactions.
- It is up to taxpayers and advisors to keep up with what the IRS posts to this list. There is no ignorance defense.



IRC 831(b) Example

- It would not be surprising to find a captive transaction that involves a captive being used as a tax deductible vehicle to fund some sort of investment, and either (a) severely overstates coverage costs, or (b) improperly distributes risk, as a transaction of interest.



Promoter Investigations

- If IRS finds several taxpayers who have a common advisor or pool that appear to be taking the same abusive activity, IRS may open a promoter examination of the advisor.
- If IRS determines the advisor is a promoter, IRS may penalize them as such at the close of the investigation.



IRC 831(b) Example (1 of 2)

- **IRS Personnel Statements Include:**
 - IRS planning on bringing “a great many” CIC cases
 - IRS planning on “expanding” promoter exams
 - IRS very interested in the “investments” as driver for CIC formation & operation
 - IRS concerned with promotional material that focuses on tax benefits & investment return
 - IRS hiring private sector forensic personnel required for ramping up caseload



IRC 831(b) Example (2 of 2)

- Forensic audits of taxpayers.
 - IRS will drill down deep into a case
 - Determining issues that should concern IRS
 - Common touch points across other cases
 - Specific professionals or risk pools in common
- Open 6700 promoter examinations of:
 - Risk Pools
 - CIC companies



List Maintenance Requests

- The IRS can request a list of all clients of an advisor, or pool participants if investigation is of a pool.
- Where IRS has found an offending taxpayer, this tool allows IRS to quickly locate a large number of potential taxpayers to audit that may have done the same thing.
- IRS will look for similar touch points among taxpayers to map out the web of promoters.



IRC 831(b) Example

- IRS finds one captive that has risk distributed improperly in a pool.
- IRS will request the pool to provide a list of all participants, and then will audit some or all of the participants, to see if the pool has improperly risk distributed all its participant captives.



Criminal Investigations

- CID investigations can now progress simultaneously with civil promoter examinations.
- A promoter exam can be referred to CID for potential criminal prosecution.
- This is obviously reserved for the worst actors.
- To date, these cases appear to involve “pretend we are doing it right” discussions with taxpayers.



IRC 831(b) Example

- Criminal warrants issued in cases in several states.
 - Risk Pools
 - Captive professionals
- Grand jury indictment in one advanced case.
 - Clients told better not to make claims
 - Promoters focused on tax savings (not insurance)



Dirty Dozen Listing

- Covering Ordinary or Implausible Risks
- Structured Maximized Premiums
- Poor Actuarial Substantiation
- Excessive Fees Charged to Unsophisticated Taxpayers



Senate Finance Committee

- Raise premium cap to \$2.2m but **lose 831(b)** qualification if **no more than 20%** of premium from one insured.
- Proposal tabled, while IRS investigates estate planning in captives.
- Sen. Grassley is a very serious opponent to abusive tax avoidance transactions.
- IRS will take investigation seriously.
- Legislation is likely to result to curb abuses.



Where is this Going?

IRS Investigation Pattern Familiar

- First: targeted forensic audits
- Discover common denominators
- Begin 6700 promoter investigations
- Begin criminal investigations
- Broad based warnings to taxpayers
- **We are here**
- Issue broad based guidance
- Start broad audit program based on guidance



THE END

[#ACIInsurance](#)



#ACIInsurance



#ACIInsurance



#ACIInsurance



#ACIInsurance



#ACIInsurance



#ACIInsurance



#ACIInsurance



#ACIInsurance



#ACIInsurance

