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House of Cards: The Implosion of the Bleeding Edge 831(b) Captive Industry

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Editor's Note: Following we have a viewpoint of the offshoot of Artex and other providers' alleged misconduct. This is provided by **Beckett G. Cantley,** who teaches international taxation at Northeastern, and **Geoffrey C. Dietrich.** Both are shareholders in Cantley Dietrich, P.C., and they can be reached at bgcantley@cantleydietrich.com and gcdietrich@cantleydietrich.com, respectively. This article is discussing the same lawsuit discussed elsewhere in this issue, *Shivkov v. Artex Risk Solutions, Inc.,* Case No. 2:18-cv-04514-GMS (D. Ariz. Dec. 6, 2018), but references a different plaintiff. It should be noted that Mr. Cantley has a cocounsel arrangement with the tax shelter practice of Loewinsohn Flegle Deary Simon LLP, counsel for the plaintiffs.

Our prior articles on Internal Revenue Code (IRC) section 831(b) captive insurance company (CIC) transactions indicated the likely future would be littered with the corpses of certain promoter groups who had run "roughshod" over the codified doctrines of economic substance and business purpose. (Most of our prior articles on the topic are available at www.cantleydietrich.com.)

This article addresses the recently filed class action lawsuit against certain captive insurance promoters and captive managers—*Phoenix 2010 Revocable Trust v. Artex Risk Solutions Inc.,* No. 2:18-cv-04514-GMS (D. Ariz. Dec. 6, 2018) (hereafter "Phoenix Trust"). Counsel for plaintiffs is David R. Deary, Esq., of Loewinsohn Flegle Deary & Simon LLP, of Dallas, Texas—and then provides analysis on the prospective court case. Given that the attorneys involved in the lawsuit plan to file more such class action suits (see below), it is important for the 831(b) captive insurance community to understand this initial case.

The current advice of certain CIC managers and promoters is to cast doubt that *Avrahami v. Commissioner,* 149 T.C. 7 (Aug. 21, 2017), and *Reserve Mechanical Corp. v. Commissioner,* 115 T.C.M. (CCH) 1475, T.C. Memo. 2018-86, mean what these cases clearly articulate and that the future is far brighter than the rapidly setting sun of promoter-led CIC transactions indicates. The vast number

of CIC promoter articles that decry the vagaries of the Tax Court decisions buoys our assessment of this trend. Certain unscrupulous promoters peddle the belief that Tax Court decisions are momentary setbacks in the industry, rather than warning signals of the impending storm. Recent CIC transaction audit reports illustrate that despite promoter belief to the contrary, the direction of the Internal Revenue Service (IRS) appears to travel down the well-worn path of antiabuse compliance.

The Recent Lawsuit

In *Phoenix Trust,* there are numerous representative plaintiff groups, all of whom had a similar experience and—for the sake of brevity—will be hereafter referred to as the Phoenix Plaintiffs. The following discussion is on the allegations of the complaint.

Similar to the taxpayers in *Avrahami* and *Reserve Mechanical,* a trusted adviser of the Phoenix Plaintiffs had been approached about providing tax strategies to their clients. As the Phoenix Plaintiffs entered into the CIC arrangements, none had a completed feasibility study explaining why the CIC was necessary or that there were risks their commercial insurance could not prevent. Across the board, the actuary and captive manager/promoter (Artex) worked together to determine rates, tables, and premiums based on the anticipated tax deduction requested. Further sweetening the deal for the proposed CIC, Artex structured the transactions so the Phoenix Plaintiffs could "borrow back" excess funds used in the insurance arrangements. In a final masterstroke, Artex purported to provide "estate planning captives" where ownership of the CIC was held by trusts for the benefit of the owners' children.

Artex, for its part, used the façade of experience to "assist" owners of closely held companies to form multiple CICs. Artex would further disguise their collusive activities through a false risk distribution platform, Provincial Insurance, PCC. The complaint claims that **Karl Huish,** the prior owner of Tribeca Risk Advisors and now Artex, and a family member, are the indirect owners of Provincial. The agreements between Artex and the insureds required the insured entities purchase insurance policies from Provincial, which would then flow premium dollars back into the client captives, less any losses, of which there were practically none.

The IRS concluded that all of the Phoenix Plaintiffs' diverse transactions lacked economic substance sufficient to pass muster and further determined, like *Avrahami* and *Reserve Mechanical,* that the arrangement was not insurance for tax purposes. The IRS concluded that the premiums were not deductible and assessed back taxes, penalties for underreporting and underpayment, and interest. The complaint further asserts that the Artex-promoted transactions were actually the result of a conspiracy involving the named defendants and "other participants." These "other participants" included other professionals such as tax attorneys, certified public accountants, and financial advisers who steered their clients into the Artex scheme in exchange for referral fees paid by Artex or another defendant.

As we have consistently warned, professionals who have the knowledge and/or ability to research and conduct due diligence into these types of transactions are now being roped into litigation because they should have known or were willfully ignorant of the Artex scheme.

In what may come as a surprise to some—and may verify what others have known all along—the complaint alleges violations of federal and Arizona Racketeer Influenced and Corrupt Organizations Act (RICO) statutes. The complaint alleges the collusion and conspiracy of both the named defendants and the other participants. Simply put, Artex and named defendants are alleged to have collud-

ed with the other participants to sell a tax shelter arrangement to obtain substantial fees. In addition to the RICO claims, the complaint alleges a host of others including breach of fiduciary duty, professional negligence, negligent misrepresentation by the defendants, breach of contract, fraud, aiding and abetting, and civil conspiracy. Included among named defendants are underwriters, actuaries, and their firms.

The class-action lawsuit seeks the return of penalties assessed against taxpayers and disgorgement of the management fees and other costs expended by the taxpayer during the life of the CIC.

Analysis of the Artex Complaint

Not all CICs are the same. The authors want to make it very clear that not all CIC promoters/managers are among the bad actors targeted in the complaint and the complaints to follow. There are many CIC promoters/managers who are conservative in practice and seek to strictly follow IRS and state insurance law guidance. The bad actors that are (or will be) the targets of these class-action complaints are those that created "too good to be true" structures with specific defects, most of which are described in *Avrahami* and *Reserve Mechanical.*

The *Phoenix Trust* case represents the first opportunity taxpayers have had a chance to stand against the rising tide of bad actor promoter misrepresentations. Until recently, taxpayers have largely not been informed of the landscape of reality in CIC transactions. Over the last decade, the IRS has targeted CIC promoters first with forensic audits, then promoter/risk pool audits, and now the bad actors with tax shelter captive shops are facing class-action litigation. These bad actor promoters appear to have done very little to prepare their clients for the deluge of IRS and civil litigation that is now upon them.

IRS penalty imposition as damages. The storm we predicted in prior articles has reached shore.[1] Now that the IRS is in full stride in its section 831(b) CIC enforcement activities, taxpayers, promoters, and advisers need to take account of the aftermath. The IRS is unlikely to alter its current course of enforcement as reports indicate the current Tax Court docket includes no less than 280 and, perhaps, as many as 500 pending 831(b) CIC cases.

Imposition of penalties for reportable transactions falls under the statutory, nonappealable penalty sections of 6707 and 6707A.[2] As we have seen, the IRS often expands reporting requirements retroactively and seeks to enforce penalties back to the retroactive date.[3] It is possible for a business owner to be assessed penalties that date back to their first year of participation in the abusive CIC captive shel-

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[1] *See* Beckett G. Cantley, *Relearning the Lesson: IRS Judicial Doctrine Attacks on the Captive Insurance Company Pre-Planned Tax Deductible Life Insurance Tax Shelter,* 14 Hous. Bus. & Tax L.J. 179, 2015; Beckett G. Cantley, *Repeat as Necessary: Historical IRS Policy Weapons to Combat Conduit Captive Insurance Company Deductible Purchases of Life Insurance,* 13 U. C. Davis Bus. L.J., 1, 2013; Beckett G. Cantley, *The Forgotten Taxation Landmine: Application of the Accumulated Earnings Tax to IRC Sec. 831(b) Captive Insurance Companies,* 11 Rich. J. Global L. & Bus. 159, 2012; Beckett G. Cantley, *Steering into the Storm: Amplification of Captive Insurance Company Compliance Issues in the Offshore Tax Crackdown,* 12 Hous. Bus & Tax L. J. 224, 2012. All articles are available at https://www.cantleydietrich.com/Articles.

[2] IRC Sections 6707(b)(1) & 6707A(b)(2)(A). Where the taxpayer participated in a reportable transaction, the penalty incurred is 75 percent of the decrease in tax or $50,000 and a separate penalty for $50,000 for failure to report.

[3] *See Soni v. Commissioner,* T.C. Memo. 2013-30, at 8. "This Court has decided previously that taxpayers may be liable for a penalty arising from a transaction entered into before the penalty was enacted." See also, *Licari v. Commissioner,* 946 F.2d 690 (1991) (holding that the imposition of the penalty retroactively benefits the public revenue by encouraging those taxpayers with whom the IRS has made no previous contact to amend tax returns).

ter, provided the income tax return statute of limitations has not run out.

The IRS now seems to be adopting a rule-of-thumb in assessments, where tax years up to and including 2010 are being hit with 20 percent penalties, and those after 2010 are being assessed penalties at the 40 percent rate.[4] Attorney David R. Deary, who is leading the Artex class-action litigation team, recently commented that "the Service has become increasingly aggressive in audits and in public statements about imposing penalties ranging from 20 to 40 percent on these transactions; we will be seeking to recover these as an element of damage in all our cases."

Only the first of several class actions. The Artex class-action case is only the first of several similar CIC-based class-action complaints that are being drafted for filing in the near future. The law firm that brought the Artex case has numerous clients in tow that participated in CICs with the bad actors of the industry. He recently confirmed this when he stated, "We anticipate the filing of additional class actions in the near future against other major promoters of these transactions." Mr. Deary also confirmed that these actions are being brought only against the truly noncompliant CIC promoters/managers and not a witch hunt being brought against the entire CIC industry.

Conclusion

Phoenix Trust is the first in a series of antipromoter class-action lawsuits that will be filed against the worst offenders in the captive industry. Concerned attorneys, accountants, and wealth managers should carefully consider the needs of their clients involved in CIC transactions. Certainly, not every promoter/captive manager is in the position of Artex. Artex has been, after all, in a promoter audit, and their clients have had the IRS deny premium deductions and assess penalties. This makes it the most likely and an easy target of opportunity for the initial class action. The prudent adviser's concerns should increase as a client's captive manager starts to look more and more like Artex.

[4]For a case study analysis on the potential penalties assessed against promoters, see Jay Adkisson, "Class Action Targets Arthur J. Gallagher & Co. over Captive Insurance Tax Shelter," Forbes, December 10, 2018.