Today & Tomorrow: Current Hot IRS Enforcement Issues & The Internal Revenue Code Of 2014

PROF. BECKETT G. CANTLEY
ATLANTA'S JOHN MARSHALL LAW SCHOOL
TEL. (404) 502-6716
BCANTLEY@JOHNMARSHALL.EDU

Presentation Outline

- IRS Structural Issues Effecting Enforcement
- Emerging Hot IRS Enforcement Topics
  - Haven't We Been Here Before?
  - IRC 831(b) Captive Insurance Companies
  - Conservation Easements in Pass-through Entities
- The Internal Revenue Code of 2014

IRS Structural Issues Effecting Enforcement

- Affordable Health Care Act (Obamacare)
  - Treas. Reg. writing & interpretations
  - Monthly enforcement nationwide
  - Personnel significantly stretched
  - Can only get worse as Obamacare rolls out
- Offshore Enforcement
  - Endless sea to troll
  - More & more compliance means more personnel time
- Tax Preparer Regulation & Oversight
  - Rapid growth on both counts
- Tax Litigators: “Empty Police Car”
  - Stretched resources
  - If cops happen to be in the car, need to make an “example”

Haven’t We Been Here Before?

- In 2000s tax shelters were crushed
  - Legislation gave IRS huge weapons
  - IRS has a sophisticated system when used
  - IRS uses very high civil & criminal penalties
  - Everyone should have learned their lessons
- Why are there so many promoters again?
  - New generation of promoter & client
  - If hand never burned, only see no crackdown as sign of IRS acceptance
  - Promotes think IRS front line auditors are not sophisticated enough to figure it out.

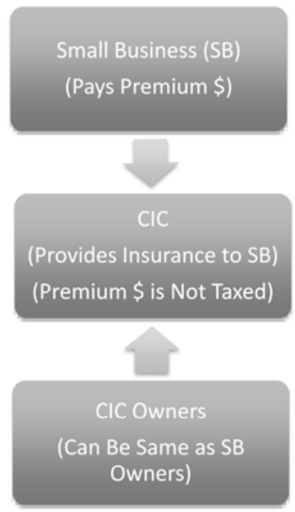
Reality Check

- Office of Tax Shelter Analysis (OTSA) scours deals for frequency & severity of problem
- IRS now coordinates audits when needed
- Criminal & civil audits can proceed same time
- Promoter exams & list maintenance requests
- Use results to make spider web mapping of US on coordinated tax shelter issues
- <u>DOJ Tax</u> is <u>not</u> a front line auditor – they are very good
- Audit costs alone kill economics of any aggressive deal
- IRC 412(i) is good example of process
- Don’t tempt fate!

IRC 831(b) CIC Structure & Potential Benefits

New Target: Police out of the Car
to Challenge Certain Activities

Typical Structure of a IRC Sec. 831(b) Captive Insurance Company ("CIC")



Sample of Possible Non-Tax Benefits

- Reduce Insurance Costs
  - Cutting out the middle man's profit
  - Insurance company commissions & overhead
  - Tailor coverage so not paying for what not needed
- Insuring the Uninsurable
  - Cannot get commercial coverage
  - Cannot get enough coverage
  - Exclusions & Exemptions reduced or eliminated

IRC s. 831(b) Potential Tax Attributes

- Premiums up to $1.2m/yr are Deductible
  - Hard to imagine getting exactly to $1.2m
  - Seems a lot like a “device” for tax avoidance if maxed out
- Premiums Received by CIC are Not Currently Taxed
- Profits Distributed to CIC Owners – Dividend Rates (15%)
- Return of Premium if Required – Dividend Rates (15%)
- Result Under Current Law: Conversion from 35% to 15%
- Tax on Premiums Paid Deferred Until Distributed
- Tax on Investments at Corporate Rates (35%)

Insurable Risks & Risk Pools

Promoter Audit Letters Sent Out to Certain Pools

No Definition of “Insurance”

- The IRC does not define “insurance”
- Insurance is defined by certain IRS pronouncements and case law
- Insurance obviously relates to the shifting and spreading of risks between parties
- The risk shifting and risk distribution requirements (discussed below) are the general requirements

Risk Shifting & Risk Distribution Basics

- <u>Risk Shifting</u> means real risk is passed on to the captive, & the captive shifts risks to others
- <u>Ex</u>. Insurance issuer agrees to share risk of loss with insured for risk of lawsuit.
- <u>Risk Distribution</u> means that the risk shifted to the other parties is properly distributed among those parties.
- <u>Ex</u>. Insurance issuer re-insures the risk by agreeing to share the risk of loss of a suit with several other insurance companies.

Risk Shifting & Risk Distribution Safe Harbors

- IRS has issued safe harbors for risk shifting
  - Ex. Rev. Rul. 2002-90, 2008-8
  - Ex. IRC Prop. Rul. on Serial LLC Cell Structures issued at FR Doc. 2010-22793
- Pure Captives – Reinsurance & Reserves
- Risk Pools for 50%+ risk shift to third parties
- Series or Segregated Cell Captives
  - 12+ Cells Cross-Insure Risks

Insurable Risks - DBAD

- Types of Insurable Risks
  - Insure current risks such as E&O and P&C
  - Insure more remote risks inexpensively (cut out middle man)
  - Remember: buying CIC insurance must make commercial sense

- Improper Risks to Insure
  - Only increasing deductibles on existing insurance coverage and insuring the difference
  - Only insuring remote risks
  - Only replacing current risks you can get commercial coverage for cheaply
  - Only adding additional risks for which inexpensive commercial insurance is available

- Questionable Risks to Insure
  - Only insuring a combination of the above “improper risks” (that would be certainly improper on their own)

- Commercially reasonable?
  - How do you explain $1m on remote risks to IRS?
  - How do you explain $1m on risks that are commercially insurable for less?
  - The IRS will want to know why you would ever do this.

Insuring Real Risks

- Insuring the uninsurable
  - If you cannot get the insurance commercially, and you have the risks, its commercially reasonable to buy the insurance to cover the risks
- Look at current policy for risks not covered
  - Exclusions & Exemptions
  - Is there a tangible risk that falls into the E&E?
  - How many similar potential situations?
  - How far back is the statute of limitations?
  - Would a tail policy to cover these risks make sense?

New Promoter Audits

- Tax shelter promoter letters – recent
- Terrorism insurance – one target
- Information gathering at risk pool level
- Same promoter mechanism as 2000's
  - Information gathered from clients using lists
  - Prove up risk shifting & distribution
  - Economic substance of pools
  - Figure out "good guys" & "bad guys"

CIC Owner Life Insurance

UC Davis School of Law Article

Re-learning the Lesson

Everyone Forgets the IRS Wins these Cases Every Time!

- Deductible premium life insurance is holy grail
  - IRC 419
  - IRC 412(i)
  - COLI
  - PORCS
- Latest Attempt:
  - CIC "invests" in LI on the life of CIC/Insured Entity Owner
- Problem:
  - IRS has made it clear it does not want double dipping
  - LI enjoys great tax benefits, deductible premiums may result in income never being taxed
  - IRS is focused on this one & has sent out promoter letters

IRS Has Many Lines of Attack Available

- Judicial Doctrines:
  - Collapse steps to prove purpose is not CIC insurance, but rather is deductible LI premiums
- Historical Tax Policy Case Law:
  - Long history of case law where IRS has successfully combatted deductible premium transactions (outside of narrow retirement account benefits).
  - <u>Prediction</u>:
    - Criminal cases for "bad guys"
    - Large civil penalties
    - Lawsuits, lawsuits, lawsuits!

Offshore v Domestic

Univ. of Houston Law Center Article

Caught Between Two Current Enforcement Areas: Cannot be Good

Offshore CIC Perceived "Benefits"

- Lower Capitalization – Jurisdictions like Nevis-St. Kitts and Cayman Islands traditionally have required lower initial capital contributions to set up a CIC
- Asset Protection – Offshore jurisdictions can require less transparency as to assets held, and provide significant speed bumps to collection of such assets using local laws (shorter statute of limitations for litigation claims, etc..)
- Fractional Programs – Several CIC arrangements exist offshore that offer the CIC structure to smaller companies making smaller premium payments. Presumably, this allows more US small businesses to make use of a CIC.
- 953(d) Election – Advisors argue that the "offshore stink" is cured by making the election to be treated as a "US taxpayer"

Offshore Tax Crackdown

- IRS is very focused on tax issues relating to offshore structures and investments.
- Senate Finance Committee 2006-Present.
- LBID: IRS just changed name of LMSB to "Large Business and International Division".
- UBS: Swiss recently relented to allow the US significantly access to Swiss Bank Accounts, even where would violate Swiss bank secrecy laws.
- Extended: HSBC India, Israel, & Criminal Indictment of another Swiss bank.

Offshore CIC Problems

- Capitalization – reducing capitalization risks judicial doctrines' application
- Asset Protection – structural complications used in AP may trigger judicial doctrines
- Fractional Programs – similar to offshore programs IRS has previously attacked
- 953(d) Election – Only makes IRS screening process for auditing offshore CICs very easy.
- Why tack your sails into a hurricane by forming a CIC offshore?

Domestic CIC Alternative

- States have similar systems to the offshore world now, and getting more user-friendly every year.
- Costs structures are similar to offshore.
- State regulators in certain jurisdictions are very communicative – they want the business!
- State law blessing of CIC structure not tainted by IRS bias against offshore jurisdictions.
- No need to leave the US for annual meetings or claims. In certain states, no need to travel there for annual meetings at all.

The Estate Planning Issue

Not Yet Known to be an IRS Enforcement Focus

Prediction: Will be Forthcoming as Budgets Tighten

Estate Planning - Upside

- Trust Holds CIC - Many CIC arrangements set up a children's trust (or other estate planning vehicle) to hold the CIC.
- Low Value at Initial Transfer - Transfer to trust made when stock at very low value
- Share Value Growth Shifts - Premiums transferred to CIC increase value of CIC shares held by trust
- Investment Value Increase Shifts - Premium and growth on premiums earned in CIC also shift to shareholder trust
- Next Generation Benefits - Presumably, the growth in CIC value and assets inures to the benefit of the next generation via the trust.

Estate Planning - Downside

- Problem: Mixing Federal Estate Tax avoidance with income tax deductions, however technically tax compliant, makes the CIC arrangement smell worse to the IRS.
  - Procedurally, IRS has different personnel for income and estate tax enforcement, so two potential sets of eyes.
  - Hogs & Pigs - Any transaction that involves both an income and estate tax element generally requires (i) more eyeballs on it, (ii) is more likely to be elevated to a higher level review, and (iii) is more likely to trigger someone sending it to the Office of Tax Shelter Analysis or to the Criminal Investigation Division because the lower level auditor does not understand it.
  - Pick Your Poison - Likely result is a "pick your poison" attack when you try to get both income deduction and gift tax reduction.

Accumulated Earnings Tax

Richmond Law School Article

Prediction: Also Forthcoming as
Budgets Tighten

Accumulated Earnings Tax (AET)

- CIC Retirement Account – advisors argue deducted premiums build like an IRA
- AET – IRS can dust off AET to tax accumulated premiums not actually needed for running an insurance company
- Avoiding AET – IRS rulings on what an insurance company needs on hand to run itself – rest has potential for AET

The Loan Back Problem

Bleeding Edge Issue

Loan Backs

- Some CIC Programs have "loan back" options to permit the client to borrow back CIC funds.
- Accomplished by borrowing against a life insurance policy or through a CIC-owned PLLC that loans the money to the client – sometimes in a split dollar life insurance arrangement.
  - Effectively, the client deducts the premium, then borrows it 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 or criminal under certain circumstances.
  - The IRS has asked for comments on the facts and circumstances that would give rise to loan back determinations.
  - We are aware of audits that focus on this issue.
- Loan backs can be attacked by:
  - Bona Fide Indebtedness, Sham Transaction, and Economic Substance Doctrines.

Enforcement Summary: Current IRS Heightened Scrutiny

- Forensic Audits – here in GA & across the US
- Open Audits - IRS has numerous (not closing)
- Guidance Forthcoming – IRS hinting at issues of significant interest
- Current State of IRS – when they move on an issue, they send a message
- Pattern - similar to how 412(i) was attacked

Conclusion: Maintain Traditional Ownership & Operation of the CIC

- The CIC should be owned and operated in a traditional way – as an insurance company.
- It is best not to own the CIC in a creative way that may increase scrutiny by the IRS, and avoid loan backs
- The IRS is going to review CICs for business purpose, step-transaction doctrine, and economic substance doctrine, so do not give them any aggressive tax avoidance bone to chew on.
- The IRS safe harbors can be followed strictly to greatly reduce or eliminate IRS tax compliance risk. Why take the risk of being aggressively creative?

Conservation Easement LLC Structures

On the Radar, but Not Yet
Actively Attacked

Conservation Easements in Pass-through Entities

- <u>Typical Structure</u>:
  - Real property in LLC
  - Real property value has increased for LLC
  - LLC owners offer LLC units for sale
  - Conservation Easement (CE) placed on real property by LLC before end of year
  - CE takes form of charitable contribution of land rights (restriction) on real property
  - Charitable contribution passes through to LLC owners (including ones who purchased LLC units)

CE: Possible Tax Benefits

- LLC Units purchased at discounted value.
- CE value is often 3.5x higher than LLC unit purchase price.
- Example. At 40% combined tax rate, $1 million LLC unit purchaser gets tax benefit of $1.4 million ($3.5m x .4).
- Seller monetizes real property gains.

Timing Issues

- If buy LLC units a few months prior to contribution, IRS can argue no substance.
- IRS may collapse steps to eliminate charitable deduction (no true purpose other than tax avoidance)
  - Economic Substance Doctrine
  - Form over Substance Doctrine
  - Step Transaction Doctrine
- IRS may treat as tax shelter w/ heightened penalty regime if no economic substance

Recipient Issue

- Many CE LLC structures donate the CE to a charitable entity whose purpose is to receive such CE donations.
- <u>Problem</u>: IRS may view the charitable entity as a tax shelter promoter, or as an entity not formed for purely charitable purposes
  - IRS may use promoter list maintenance rules to audit all LLC contributors to charity of CEs.
- <u>Better</u>: Donation to State or Local Government

Enforcement Status

- IRS has not yet broadly attacked LLC deal
- IRS has notified W&M of issue
  - Annual deduction % of AGI was temporarily raised from 30% to 50% (ended 1/1/12)
  - LLC CE Deals appear to have stalled efforts to raise CE deduction % to 50% more permanently
  - Land trusts have referenced this issue as one that needs resolution before 50% is politically viable
  - Conclusion: if IRS concerns are stalling W&M on CE benefits over issue, IRS likely ready to turn it into an enforcement issue soon

Political Considerations

- Conservation Easements have fit into Obama Administration environmental priorities
- Romney unlikely to see it the same way
  – Romney will be looking for revenue raisers
  – Corruption & failure of stimulus environmental projects make this an easy target to crack down
  – Key: if done substantively, to governmental entity, & with true donative intent, likely still viable

Internal Revenue Code of 2014

IRC of 2014: In Process

- Congress has been working on different provisions of a new IRC for a couple of years.
- Staff for different Reps. Serving on Ways & Means have been working up different proposals that are deemed important to the Representative. Some are working on sweeping structural changes.
- The Great Recession and potential debt default issues are shaping these proposals, as well as the direction of the overall reform package.

Life Cycle of the IRC

- Every new IRC starts out in a "simplified" version.
- Over time, additions made for several reasons – tax incentives, plugging holes, raising revenue through floors/ceilings, etc…
  - Bush added to Reagan, Clinton added to Bush, etc..
- Every 25-30 years, these additions complicate the IRC to the point where "simplification" comes back into vogue & a new IRC is born.
- IRC of 1986 – 2014 is 28 years & simplification is almost the only thing the GOP & Dems agree on.

What is Simplification?

- GOP & Dems Agree in principle on:
  - Fewer tax brackets
  - Fewer deductions & credits
  - Less complicated corporate taxation
  - More in sync w/ rest of world in some ways
- GOP & Dems disagree on who benefits, who is burdened more, and spending priorities that are incentivized

Income Tax Rates: Politics are Everything

- Presidential election may be determiner.
- President's re-election means rates are likely to be allowed to go higher (42%).
- Romney win likely reduces top rates & broadens tax base significantly.
- Corporate rates will go down w/ Romney.

Deductions: the Heaviest Lifting

- Both parties have members floating similar changes (Dems fixated on $250k+).
- Cautionary Tale: a lot depends on strength of lobbies & organized voter responses to members.
  - 1986 the real estate lobby did not adequately push their interests. Result was IRC 469.
  - Many small town downtowns destroyed by these new passive loss rules as store owners absorbed the new tax cost.
  - Result – expect incumbents to reap huge campaign contributions from lobbyists.

Charitable Deduction

Hardest to Change

- Reason for Change.
  - Revenue raiser
  - Merger of politics & charity easy target.
- Baucus & Grassley (SFC)
  - 2003+ tightened charitable rules, so can be done.
- Very powerful lobby
  - Hospitals, Universities, Churches, Red Cross, etc.
  - Use PR weapon to effect legislators (hard vote).
- Possible:
  - Limited for high income (30% or phased out).
  - Restrictions on which recipients qualify

Home Mortgage Interest Deduction

- 2nd Hardest to Change
  - Millions of taxpayers count on it.
  - Real estate lobby won't get caught sleeping again
- Reason for Change:
  - Revenue Raiser
  - Smooth out distortions in home market
  - If ever going to do it – now is the time (lower home ownership)
- Possible:
  - Lower purchase price cap for deducting interest ($500k?)
  - Phased out for wealthy taxpayers
  - Phased out completely over time
  - Grandfather current mortgages or phase them in

Corporate Taxation

- Reason for change:
  - Revenue raiser
  - Politically popular
    - oil prices
    - alternative energy scandals
    - anti-corporate bias
- Possible:
  - Elimination of many credits
  - Elimination of many "extenders"
  - Trade-off: lower corporate tax rates

International Taxation

- Territorial System
  - W&M studying switch
  - End worldwide income for business
- Reason for Change:
  - Repatriation of income
  - Sync system up w/ rest of world
  - More competitive for investment
  - Ease of compliance
  - End Treaty Shopping
- Possible:
  - Complete switch in 2014 (difficult)
  - Study, but put off decision to next Congress

New Taxes Possible

- Valued Added Tax
  - Tax at every level of a products creation & sale
- National Sales Tax
  - Flat rate on goods and/or services
- Reason for Change:
  - Extreme revenue raiser
  - Broaden tax base quickly
  - Serious financial problems would be driver
- Possible:
  - Unlikely in 2014 unless new financial collapse
  - Much more likely if & when next financial leg down hits

Conclusion

- New IRC is coming in 2014
- Election, Debt & Financial Problems will be determiners on big issues
- GOP goal is flatter, broader, more business-friendly tax environment
- Dem goal is higher rates & less benefits for wealthy & corporate interests
- Both GOP & Dem agree it has to be done.