

Micro-Captives and Conservation Easements: The Fine Line Between Good Tax Planning and Tax Evasion

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What is Micro-Captive Insurance?

- Legally licensed, limited purpose property and casualty insurance company that is owned by its members under IRS §831(b) operating with an annual net premium of up to \$2.2 million.
- When a company creates a captive insurance they are able to evaluate risks of subsidiaries, write policies, set premiums and either return unused funds in the form of profit or invest them for future claim payouts.



Advantages of Micro-Captive Insurance

1. Coverage that is tailored to your needs
2. Lower operating costs
3. Improved cash flow
4. Increase in coverage and capacity
5. Investment income to fund losses
6. Greater control over claims
7. Negotiating leverage with underwriters
8. Incentives for loss control
9. Current deduction for funding of future losses
10. Risk management
11. Funding for deductibles
12. Purchasing power
13. Tax rate arbitrage
14. Industry specific group captives

Micro-Captive Insurance - Issues

- No real insurance
- Lack of basis for premium pricing
- No real risk of loss
 - ~ Insuring for losses with no correlation to business covered
- Premiums greater than market price
- Ownership by generation skipping trusts
- No claims experience

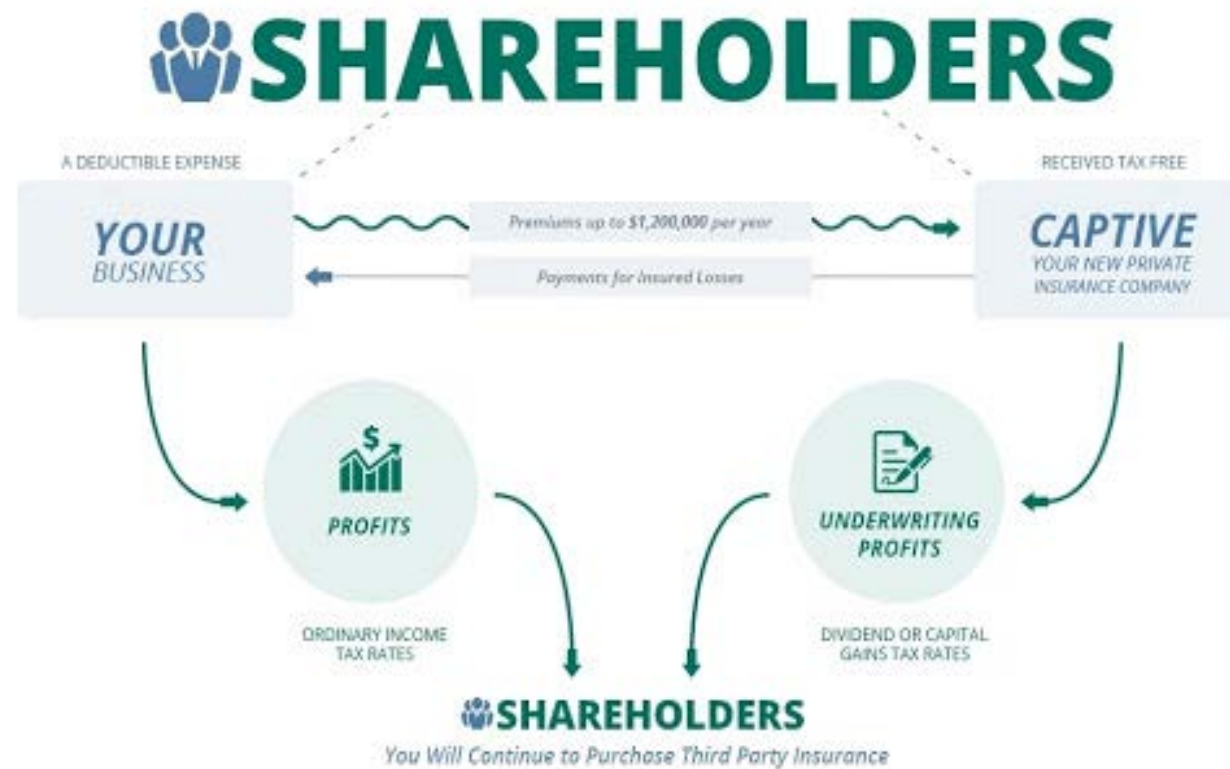
Release 2020-226

- IRS has issued release IR 2020-226 on October 1, 2020 encouraging taxpayers participating in a micro-captive insurance transaction to consult independent tax advisors in considering their future actions.
- As a result of several wins in the U.S. Tax Court, IRS has decided to offer settlements to taxpayers who are currently under exam in notices sent to up to 200 taxpayers. The Service warns that those who receive such letters and opt not to participate will continue to be audited by the IRS under its normal procedures.
- However, IRS had indicated that IRS enforcement in this area will continue. Additionally, taxpayers cannot anticipate to settle with IRS on terms which are more favorable than the current offer and they will probably need to provide additional concessions to the Service.
- IRS suggests that a taxpayer involved in an abusive micro-captive insurance transaction should seriously consider exiting the transaction and not claiming deductions associated with the transactions, as did many taxpayers who were notified in March and July of 2020.
- For those who do not, IRS will continue with enforcement efforts and can disallow tax benefits from abusive transactions and require domestic captives to include premium payments into income and assert a withholding liability for foreign captives.

Release 2020-241

- IRS has issued release IR 2020-241 on October 22, 2020 announcing a second time-limited settlement initiative for certain taxpayers under audit who participated in abusive micro-captive insurance transactions.
- The IRS will begin sending settlement offers with terms that are stricter than the IRS's first time-limited initiative started last year. This announcement occurs after the IRS recently deployed its 12 newly formed micro-captive examination teams to substantially increase the examinations of abusive micro-captive insurance transactions
- The IRS has decided to offer to resolve certain cases by requiring substantial concession of the income tax benefits claimed by the taxpayer together with penalties that can be partly mitigated if the taxpayer can demonstrate good faith, reasonable reliance on an independent, competent tax advisor and if the taxpayer can demonstrate it did not participate in any other reportable transactions.
- Because the terms of this second settlement initiative reflect the IRS's current settlement position, certain taxpayers who received but rejected an offer under the IRS first time-limited initiative may receive an offer under this second time-limited settlement initiative, but under the new, stricter terms.
- Taxpayers who receive offer letters under this settlement initiative, but who opt not to participate, will continue to be audited by the IRS under its normal procedures. Potential outcomes include, but are not limited to, full disallowance of captive insurance deductions, inclusion of income by the captive, withholding tax related to any foreign captives, and imposition of all applicable penalties.

Microcaptive Structure



“Dirty Dozen”

- Micro-Captives are featured on the “Dirty Dozen” IRS list of tax scams to avoid.
- As of March 2019 there were more than 500 docketed cases in Tax Court.
- In 2019 the IRS sent out time limited settlement offers made to certain taxpayers under audit who participated in abusive transactions.
- 80% of taxpayers who received the offer letter accepted the settlement.
- The IRS created 12 new examination teams who will be targeting these transactions



Notice 2016-66

- The IRS issued Notice 2016-66 which identified certain micro-captive transitions as having the potential for tax avoidance and evasion.
 - Under Notice 2016-66 disclosure of participation is required by the IRS. Failure to properly disclose these transactions will be subject to penalty under §6707A or §6707(a)

Transactions of Interest

Section 2.01 of Notice 2016-66 identifies transactions of Interest to be those as follows:

- a) *A, a person, directly or indirectly owns an interest in an entity (or entities) ("Insured") conducting a trade or business.*
- b) *An entity (or entities) directly or indirectly owned by A, Insured or persons related to A or Insured ("Captive") enters into a contract (or contracts), (the "Contracts") with Insured that Captive and Insured treat as insurance, or reinsures risks that Insured has initially insured with an intermediary, Company C;*
- c) *Captive makes an election under section 831(b) to be taxed only on taxable investment income;*
- d) *A, Insured, or one or more persons related to A or Insured directly or indirectly own at least 20% of the voting power or value of the outstanding stock of Captive; and*
- e) *One or both of the following apply:*
 - (1) *The amount of the liabilities incurred by Captive for insured losses and claim administration expenses during the Computation Period (generally, the prior five years, or the years the captive has been in existence if less than five years) is less than 70% of the following:*
 - (A) *premiums earned by Captive during the Computation Period, less*
 - (B) *policyholder dividends paid by Captive during the Computation Period; or*
 - (2) *Captive has at any time during the Computation Period directly or indirectly made available as financing or otherwise conveyed or agreed to make available or to convey to A, Insured, or a person related or Insured in a transaction that did not result in taxable income or gain to Recipient, any portion of the payments under the Contract, such as through a guarantee, a loan or other transfer of Captive's capital.*

Syzygy Insurance Co v. Commissioner of Internal Revenue

- In 2019 the U.S. Tax Court ruled in favor of the IRS
- The Tax Court found that captive insurer Syzygy and its fronting carriers were not insurance transactions.
- The judge ruled the fronting carriers were not insurance companies and the captive did not properly distribute risk to be treated as insurance for income tax purposes.

What is a Conservation Easement?

Voluntary Legal agreement between a landowner and a land trust or government agency that permanently limits uses of the land in order to protect its conservation value.



How Do They Work?

- A conservation easement reduces the value of land –
 - Can reduce estate taxes when property is passed to the next generation, which makes it easier to keep the land within a family.
 - Can reduce local property taxes.
- The grant of a conservation easement can give rise to a charitable deduction for the fair market value of the contribution. §170(h).
 - Restriction must be granted in perpetuity; conservation purposes must be protected in perpetuity
- Many of these transactions are syndicated, meaning that a sponsor/promoter sets up a partnership that acquires land and markets the deal to investors who would join the partnership before the grant of the conservation easement.
- The goal is for the partnership to pass through charitable deductions to the investors in an amount between 2.5x and 9x the amount invested.
 - Return usually exceeded 100% of amount invested (depending on applicable blended tax rates).

Disadvantages

- How do the charitable deductions exceed the investor's amount invested?
 - Amount of the deduction is based on a qualified appraisal that is often inflated
- [Notice 2017-10](#) (Dec. 2016) – IRS identified these and substantially similar transactions as listed transactions
 - Disclosure requirements for participants (Form 8886 with OTSA in first year, and with IRS in each year affected)
 - Failure to disclose extends the statute of limitations. §6501(c)(10); Reg. §301.6501(c)-1(g).
 - Disclosure and list maintenance requirements on material advisors, including appraisers, that make tax statements
 - IRS will assert penalties on participants, promoters, and material advisors
 - IRS will assert penalties on tax preparers under §6694

Disadvantages (cont'd)

- [DOJ Press Release 18-1672](#) (Dec. 2018) – DOJ announced that it sued to shut down a large promoter of these transactions
- [IR-2019-47](#) (March 2019) – IRS added these transactions to its annual “Dirty Dozen” list of tax scams
- [IR 2019-182](#) (Nov. 2019) -- IRS announced large-scale civil and criminal audits of these transactions
 - IRS initiating a significant increase in enforcement actions (hundreds of partnerships and thousands of investors)
 - Evaluating numerous referrals of practitioners to the IRS Office of Professional Responsibility
 - More than 80 cases docketed in Tax Court
 - Taxpayers may avoid penalties if they timely file a qualified amended return or administrative adjustment request to remove the improper charitable deductions

Disadvantages (cont'd)

- Note that a qualified amended return must be filed before the earlier of –
 - (i) the date the taxpayer is first contacted by the IRS regarding a civil or criminal examination of the return,
 - (ii) the date the partnership or any promotor of the easement transaction is contacted concerning the partnership tax return or the conservation easement transaction,
 - (iii) the date the IRS serves a John Doe summons relating to the transaction, or
 - (iv) the date the IRS announces by “revenue ruling, revenue procedure, notice, or announcement, to be published in the Internal Revenue Bulletin (see §601.601(d)(2) of this chapter) a settlement initiative to compromise or waive penalties, in whole or in part, with respect to a listed transaction.” Reg. §1.6664-2(c)(3).

Disadvantages (cont'd)

- [IR 2020-130](#) (June 2020) – IRS announced a settlement initiative for docketed Tax Court cases, and that it intends to mail letters to affected taxpayers that will include the following terms:
 - The deduction for the contributed easement is disallowed in full
 - All partners must agree to settle, and the partnership must pay the full amount of tax, penalties and interest before settlement
 - “Investor” partners can deduct their cost of acquiring their partnership interests and pay a reduced penalty of 10 to 20% depending on the ratio of the deduction claimed to partnership investment
 - Partners who provided services in connection with ANY Syndicated Conservation Easement transaction must pay the maximum penalty asserted by IRS (typically 40%) with no deduction for costs

Disadvantages (cont'd)

SYNDICATED CONSERVATION-EASEMENT TRANSACTIONS

—
BIPARTISAN INVESTIGATIVE REPORT
AS SUBMITTED BY CHAIRMAN GRASSLEY
AND RANKING MEMBER WYDEN
—

COMMITTEE ON FINANCE
UNITED STATES SENATE

CHARLES E. GRASSLEY, *Chairman*
RON WYDEN, *Ranking Member*



AUGUST 2020

Disadvantages (cont'd)

SYNDICATED CONSERVATION-EASEMENT TRANSACTIONS

“I would steer well clear of this. It is a ‘syndicated conservation easement’ tax shelter deal. These have been labeled tax avoidance transactions by the IRS, and are ‘listed transactions.’ An audit is guaranteed. And the odds are heavily in favor of the IRS prevailing. How do you justify paying less than \$3 million for a property that an appraiser says is worth \$81 million, with a conservation easement worth \$78 million?”¹

—Email from independent attorney to potential investor in syndicated conservation-easement transaction

1. Introduction

This report discusses the findings of the United States Senate Committee on Finance’s investigation into syndicated conservation-easement transactions. The investigation began on March 27, 2019,

Disadvantages (cont'd)

➤ [Senate Finance Committee Report](#) (Aug. 2020)

- Between 2010 and 2017, syndicated transactions generated about \$26.8 billion of charitable contribution deductions for investors
- As of February 2020, IRS is either auditing or planning to audit 84% of identified partnerships
- “Imagine walking up to a vending machine with a sign on it that read, “The Dollar Machine.” Instead of selling sodas or candy for a small amount, this supposed Dollar Machine offered to give you two dollar bills back for every dollar bill you inserted. This would be a simple, 100-percent return on investment, virtually guaranteed.”
- “This is essentially what promoters of syndicated-conservation easement transactions promised their taxpayer-investors every year: for every dollar you give us, you will get back two dollars, sometimes a little more and sometimes a little less. But it was not the promoters who gave back the two dollars; it was the Federal government by way of foregone tax revenue, and the only risk involved was whether or not the transaction would lead to an audit.”

Disadvantages (cont'd)

- AM 2020-010 (Oct. 2020) – IRS Chief Counsel addresses fraud penalty in TEFRA syndicated conservation easement cases
 - Addressed civil fraud penalty under §6663(a) to partnerships under TEFRA
 - Penalty applies if the facts/circumstances establish, by clear and convincing evidence, the willful intent to evade tax at the partnership level
 - If proved, the penalty applies to all partners for any underpayments of tax attributable to the fraud, and any additional underpayments for the same year
 - Partners can then raise any partner-level defenses in a refund action

Tax Issues

- Overvalued appraisals
 - ~ Inflated value of easements
 - ~ Unreasonable factual assumptions and conclusions about development potential of the real property
- Credentials and qualifications of appraisor
- No real restrictions given up
 - ~ A taxpayer cannot give up a right that he or she does not have
- Syndicated conservation easements
 - ~ Corresponding tax savings that exceed the amount invested
- Charitable intent

Recent Tax Court Cases

- Hewitt v. Commissioner – charitable deduction of \$2.8 million claimed; deduction denied but no penalties imposed.
- Lumpkin One Five Six v. Commissioner – charitable deduction of \$2.48 million claimed; deduction was denied in full.
- Habitat Green Investments, LLC et al. v. Commissioner – partnerships claimed deductions for \$19.1 million, \$19.6 million, and \$28.5 million; all deductions were disallowed, and penalties were not determined.



