Seeking IRS Accountability For Faulty Microcaptive Notice

By **Joshua Smeltzer** (April 20, 2023)

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Taxpayers in Standard Insurances Company v. U.S., in the U.S. District Court for the District of Utah, Central Division, are seeking to expand the reach of earlier wins in microcaptive insurance cases to include other districts and, potentially, other arguments limiting the use of information obtained improperly by the Internal Revenue Service.

Although microcaptive insurance transactions have had mixed results in the courts, it seems clear that there is agreement that the IRS overstepped its authority in issuing a notice requiring affirmative reporting.

As courts grapple with the authority and reach their rulings have on taxpayers within their own districts and throughout the country, the potential punishment for this overstepping is not yet known. However, if the IRS suffers little or no harm in failing to properly issue an official notice, there will be little incentive to avoid doing so in the future.

Therefore, the issue is not specific to the taxpayers effected, but all taxpayers who may face allegedly official requirements from IRS notices in the future.

Section 831(b), which provides benefits from small insurance companies — i.e., net premiums received are not taxed as income up to $2.2 million — was enacted in 1986 and was regularly approved by the IRS. However, the tide started changing when microcaptives showed up on the IRS dirty dozen list and stayed there for multiple years.

In 2016, the IRS also issued Notice 2016-66 claiming that the structures have potential for tax avoidance and evasion, and establishing reporting requirements for such transactions. The IRS rallied its troops — with an exam team called the "Tiger Team" — and used the reporting requirements of Notice 2016-66 to force all microcaptive arrangements to raise their hand for audit.

Those who have had the misfortune of being on the receiving end of an IRS audit, especially one for a transaction already targeted as potentially abusive, knows the process is long, expensive and generally unpleasant.

Following these audits, the first government wins appeared in the U.S. Tax Court with Avrahami v. Commissioner in 2017 and Reserve Mechanical Corp. v. Commissioner in 2018.

In both Avrahami and Reserve Mechanical the court claimed that the arrangements were not insurance. The Reserve Mechanical decision would be affirmed in 2022 by the U.S. Court of Appeals for the Tenth Circuit.[1]

Despite all this activity for microcaptive arrangements, in CIC Services LLC v. Commissioner, discussed below, the U.S. Supreme Court would allow one manager of captive insurance companies to challenge the notice as improper, and on remand the Notice 2016-66 was officially invalidated. However, when the government cried foul the decision was limited only to the parties in the case, not all taxpayers.

Hundreds of other microcaptive arrangements throughout the country are now left

wondering whether they will receive the same, better or worse result in their own cases.

The Long Road to Tax Issue Resolution

An IRS audit notice is, arguably, a terrible thing to receive. It carries with it a potentially unknown time frame, cost and ultimate result.

Although several protections have been implemented, such as Taxpayer Bill of Rights I, II and III, the process is still a very long and arduous journey. This is especially true for certain tax transactions that gain the attention of the IRS and become coordinated issues.

Currently, microcaptive insurance arrangements and syndicated conservation easement arrangements are filling the IRS examination files and courts because of coordinated efforts by the IRS.

Government officials from the IRS and the U.S. Department of Justice Tax Division comment on them, and multitudes of revenue agents and government attorneys work to make sure that the government position is defended.

Boilerplate information requests are drafted and used by revenue agents during audits, technical advisers are consulted at the audit level and even during conferences involving the allegedly independent IRS Office of Appeals, and IRS counsel attorneys may even show up at the audit level to oversee the examination and investigation.

In short, a taxpayer involved in a microcaptive arrangement can expect a very long audit process, with multiple IRS agents, attorneys and other personnel involved protecting the government's interest.

In 2019 and 2020, the IRS offered settlement initiatives for microcaptive arrangements and many taxpayers, facing a long road to resolution, have considered and entered into settlements. However, the settlement initiative doesn't make sense for some taxpayers, leaving them with the options of accepting large adjustments and penalties or fighting.

The adage "you can't fight city hall" isn't always true either — sometimes there is still a chance to win in court. One such case in U.S. tax court, Puglisi v. Commissioner,[2] involved a $2.7 million alleged deficiency that was conceded prior to trial.

Even though the case appeared to fit the mold of other cases in which the IRS had shown little or no mercy litigating — e.g., reinsured risks pooled by hundreds of similarly situated independent taxpayers — the government decided it wasn't worth the risk of a bad decision and, in 2021, conceded before trial.

Perhaps it was the fact that the taxpayers had found similar coverage in the commercially available market or that they had made several significant claims. Although it is encouraging that a taxpayer might be able to provide sufficient support to cause the IRS to give up, Puglisi was under the IRS microscope from 2017 until the concession in 2021.

The time, hassle and cost of such a long battle with the IRS certainly takes its toll. Especially frustrating is that the vast majority of these long audit battles, sometimes leading to litigation in court, started with an IRS notice that never should have been issued.

The Current Status of Relief for Taxpayers Complying With Notice 2016-66

In CIC Services, a manager of captive insurance companies, challenged IRS Notice 2016-66 on the grounds that it was issued in violation of the Administrative Procedure Act. The government responded with an often used and often won challenge that the challenge violated the Anti-Injunction Act.

The issue reached the Supreme Court, which in 2021 ruled that the challenge was not barred by the AIA. On remand, the U.S. District Court for the Eastern District of Tennessee finally provided relief to taxpayers in 2022, by ruling that the notice was, in fact, arbitrary and capricious in violation of the APA, and as such it was an invalid notice that could not be enforced.

The district court in CIC Services required the IRS to return documents to the taxpayers and the material advisors, but denied an injunction barring the IRS from using documents produced in response to Notice 2016-66 in other judicial proceedings.[3]

The government, however, cried foul, arguing that the court lacked the authority to order a nationwide return of all documents received pursuant to Notice 2016-66. The court ultimately agreed, despite recognizing that the decision was a windfall for the IRS, because nonparties were not properly included in the relief sought.[4]

As such, the decision provided a framework for other taxpayers to challenge Notice 2016-66 in their own cases and their own jurisdictions, but did not give them actual relief.

However, the decision also didn't necessarily foreclose other taxpayers from reasserting requests for injunctive relief that would prevent the use of information obtained from the invalidated IRS notice in judicial proceedings in their own cases or on behalf of a class of similarly situated individuals.

Holding the IRS Accountable Going Forward

Taxpayers in Standard Insurances Company are seeking injunctive relief for themselves using the same arguments that were successful in CIC Services, and also appear to be seeking declaratory relief that all audit determinations are null and should be reversed. If successful, these taxpayers would add a district court in the Tenth Circuit to the ranks of courts invalidating Notice 2016-66 for being arbitrary and capricious in violation of APA requirements.

Further, the taxpayers in that case appear to be pushing the argument for a declaratory judgment that the collection of wrongful information under the notice renders any decision based on that information null and void. The complaint outlines familiar arguments asserted in the CIC Services matter as well as specific allegations indicating that the IRS easily identified both the plaintiffs and many other taxpayers through Form 8886, a form the IRS notice requires taxpayers to file.

Although the complaint does not appear to assert any form of class action, it hints that it is likely many other taxpayers are similarly situated. Standard Insurance Company is only starting its litigation journey; however it will be interesting to see how this case develops.

The government's answer is due on April 28.

If the taxpayers are able to obtain information in discovery about the process that was used to select them for audit, and reach the adjustment decisions that were made, it could provide the framework for a class action. This would allow taxpayers, and not just the government, to coordinate the issue nationwide.

The question remains whether the IRS can move forward with or defend certain assessments if the information supporting those assessments must be returned. In general, the IRS is entitled to a presumption of correctness in its assessments and courts are prohibited from looking behind a determination, even if it is based on hearsay or other inadmissible evidence.

In limited circumstances this presumption does not apply, and the government is required to provide some factual foundation for the assessments it makes. This is usually referred to as a "naked assessment" because it lacks any foundation and the evidence supporting it is either excluded or nonexistent.

If all the information supporting the assessment in Standard Insurances Company, and other similarly situated taxpayers, is required to be returned because the IRS obtained it pursuant to an invalid notice then, presumably, the IRS would have no evidence supporting any proposed assessment. With hundreds of proposed and actual assessments called into question by the removal of underlying support for those assessments, the IRS efforts to effectively investigate, examine and litigate microcaptive cases would be even more chaotic than they have been.

Lack of evidence at the administrative level can sometimes be cured if it is supported by second-hand information or other reasonable evidence usually disclosed in discovery. However, if the second-hand information itself is sufficiently connected to the wrongful Notice 2016-66, it may not be available for government use.

There are cases where the government has still been able to use evidence wrongfully obtained in criminal proceedings to support subsequent civil tax assessments.[5] Therefore, the mere fact that the evidence was obtained wrongfully may not be enough, and would certainly be challenged by the government if raised.

Taxpayers and their lawyers will be watching cases like Standard Insurance Company to see whether they follow, limit or expand the relief received in the CIC Services decision. Perhaps, if sufficient facts are obtained and efforts combined, we may see a class action or other multidistrict litigation form so that nationwide relief can be obtained.

A class action against the U.S. in the tax context is not without precedent. In 2006, the IRS conceded certain telephone excise taxes were no longer lawful and issued Notice 2006-50, offering a procedure for taxpayers to recover taxes previously paid.

In 2012, that notice was also challenged in In re: Long-Distance Telephone Service Federal Excise Tax Refund Litigation, in the U.S. District Court for the District of Columbia, and invalidated based on the failure to follow APA requirements.

Both the wrongful excise taxes and the invalidated procedures generated several class actions by similarly situated taxpayers.

Conclusion

What taxpayers absolutely know is that IRS Notice 2016-66 was determined to be wrongfully issued and has caused significant time spent, costs, hassle and stress for those who complied.

Even the IRS, in proposed rule changes published earlier this week for microcaptive insurance transactions, acknowledges the CIC Services decision and has said it will not enforce disclosure requirements or penalties dependent on the procedural validity of Notice 2016-66.

The IRS also, in the same proposed rule changes, "obsoletes" the notice with a caveat that it claims no effect on the merits of the tax benefits claimed related to current litigation or examinations.

The invalidated IRS notice was absolutely used to investigate, audit and propose or actually assess tax, all as a direct result of wrongful action by the IRS. What remains to be determined is the proper punishment for the effects of such wrongful action on taxpayers other than those in the CIC Services case, since that decision was limited to the parties.

If the IRS isn't held accountable in some fashion, it has no incentive to follow the proper procedures under the APA or other laws going forward. If the benefit outweighs the cost, then the wrongful actions will certainly continue.

Taxpayers and their advisers should evaluate cases as they arise, assess their particular factual situations and determine what rights they could assert individually or as a group if they also complied with Notice 2016-66 to their detriment.

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[1] Reserve Mechanical Corporation v. Comm'r, 129 AFTR 2d 2022-1804 (10th Cir. 2022).

[2] Puglisi et al. v. Comm'r, 2021 WL 7162530 (U.S. Tax Court 2021).

[3] See CIC Services LLC v. IRS, 592 F. Supp. 3d 677 (E. D. Tenn. 2022).

[4] See CIC Services LLC v. IRS, 2022 WL 2078036 (E.D. Tenn. 2022).

[5] See U.S. v. Janis, 428 U.S. 433 (1976).