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AVRAHAMI V. COMMISSIONER: THE MUCH ANTICIPATED FIRST CASE EXAMINING THE VALIDITY OF A MICROCAPTIVE INSURANCE COMPANY

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The U.S. Tax Court, in Avrahami v. Commissioner, decided, for the first time, what it takes for a captive insurance company making a Section 831(b) election (a "microcaptive") to qualify as an insurance company. While the Avrahami opinion is primarily relevant to microcaptives, aspects of the Tax Court's discussion on risk distribution and insurance pools are relevant for captives that have not made an 831(b) election. The author of this article discusses the decision and next steps.

Just over 75 years after the U.S. Supreme Court decided *Helvering v. Le Gierse*,[1] where the Court first considered what is required to constitute insurance for Federal tax purposes, the U.S. Tax Court, in *Avrahami v. Commissioner*,[2] decided, for the first time, what it takes for a captive insurance company making a Section 831(b) election (a "microcaptive") to qualify as an insurance company. Significantly, the Internal Revenue Service ("IRS") contended that abusive tax planning was involved in both cases; in the 1941 case, the Supreme Court did not permit the use of a combined annuity and insurance policy designed to avoid estate tax,[3] and in the 2017 case, the Tax Court viewed the microcaptive with scrutiny, acknowledging the potential for income and estate planning abuse.[4]

While the *Avrahami* opinion is primarily relevant to microcaptives, aspects of the Tax Court's discussion on risk distribution and insurance pools are relevant for captives that have not made an 831(b) election. For business owners currently utilizing a microcaptive, *Avrahami* provides some perspective as to how the Tax Court, as opposed to the IRS, would test a microcaptive under the long-standing case law which was developed in IRS disputes involving captives owned by large companies.

Microcaptive Background

The "microcaptive" came into being as part of the Tax Reform Act of 1986, but tax breaks for small insurers existed as far back as 1924.[5] Thus, small insurers have historically been able to exclude underwriting income from their gross income. But with an increase in the amount of premium that could be excluded under the 1986 amendment, the 831(b) election provided an opportunity or, as the court put it, a "loophole at the intersection of section 831 and captive insurance caselaw" that was simply too good to pass up. Consequently, the use of microcaptives to write unrealistic "implausible" risks became a popular estate planning strategy for some. Planners favored this because the build-up of surplus (from the lack of claims) meant that tax deductible dollars could be used to purchase life insurance (generating various ancillary benefits). Surplus could also be employed to make loans to family members or back to the operating entity (the dreaded "circular flow of funds.") If the captive were owned by the business owner's children, the captive structure could be used to sidestep gift, estate and generation-skipping transfer taxes.[6]

The IRS continued to apply increased scrutiny to the use of 831(b) captives, adding them to the annual "Dirty Dozen" list in 2015 and designating certain 831(b) captives as "transactions of interest" for purposes of the reportable transaction rules in 2016. But it wasn't until August 21, 2017, a day of solar eclipse, that the Tax Court in *Avrahami* provided an opinion that would shed judicial light on the microcaptive world. Whereas the IRS view of 831(b) captives was well known, it remained to be seen whether the Tax Court would view the microcaptive with the same degree of skepticism as the Service had for several years.

The IRS Adjustments

The Service challenged the *Avrahami* captive on numerous grounds, essentially holding the captive lacked substance and was used for primarily tax avoidance purposes. Through the denial of deductions in audit, the IRS was seeking nearly $380,000 for 2009, $990,000 for 2010, plus almost $275,000 in penalties. Some have theorized that perhaps the court would permit such planning, since Section 831(b) does not explicitly prohibit the use of policies that seem (at least objectively) unusual or unnecessary.

The captive structure was set up such that there were several operating companies (taxed as pass-throughs as to their owners, the Avrahamis) paying premiums to the captive. Thus, as a result of the denial of deductions, there would be an increase in income (and consequently, income tax, interest and penalties) to the Avrahamis due to the pass-through nature of those insured entities. During the course of operations, there were multiple transfers characterized as loans, including a transfer of $200,000 from the captive to Mrs. Avrhahami – which the parties stipulated as a dividend.[7]

Overview and Significance of the Opinion

In *Avrahami*, the court left no stone uncovered, applying significant scrutiny to the microcaptive structure, focusing on numerous issues, including the actuarial calculations used to determine premiums, the use of surplus built up in the captive, email communications revealing Mr. Avrahami would "freak out" if funds were not returned, the fronting carrier for the risk pool and the lack of claims prior to the IRS audit. The result, although based on an intensive review of very specific facts and circumstances for the *Avrahami* structure, provides guidance that will allow current business owners participating in a captive arrangement to assess the soundness of the captive in the event of challenge by the taxing authority, and gives critical guidance to both prospective captive owners and captive managers. Furthermore, *Avrahami* demonstrates what factors the court thinks are important to determining whether a captive "represents insurance in the common sense"; these considerations may inform an economic substance analysis in future cases. For those currently in various stages of tax controversy, *Avrahami* should be considered when deciding the exposure to penalties now that guidance is available. Importantly, the opinion does not address the Service's other arguments against microcaptives (*i.e.*, risk shifting, insurance risk, economic substance, substance-over-form, and step-transaction.) Finally, this opinion may be appealed.

Background

The court began its opinion with a brief history of how the Avrahamis came upon the captive as a planning tool. The Avrahamis – who were successful business owners – initially contacted their Certified Public Accountant ("CPA") of 25 years, Craig McEntee, for advice for their flourishing business.[8] The CPA recommended the Avrahamis speak with an estate planning attorney, Neil Hiller. Hiller specialized in estate planning, employee benefits and tax. Around the same time, the CPA also suggested that a captive might be a good fit for the Avrhamis and recommended they consult with Celia Clark, an attorney with a practice focused on tax, trusts and estate planning. The court noted that Clark had first become interested in captives in 2002 and helped draft captive legislation for Saint Christopher and Nevis (St. Kitts).

Before retaining Clark, the Avrahamis consulted with Hiller, who suggested that a captive might be a good fit and recommended the Avrahamis consult with Clark. The court noted that Hiller had previously worked with Clark on another captive matter. The retainer was signed in which it was agreed that Clark and the estate planner would act as co-counsel and provide all legal services relating to the start-up of a captive in exchange for $75,000. This led to the formation of the captive, "Feedback Insurance Company, Ltd."

Feedback made both a 953(d)[9] and 831(b) election for the years at issue in this case (2009 and 2010.) Feedback entered into a "cross-insurance program to reinsure terrorism insurance for other small captive insurers through a risk-distribution pool set up by Clark exclusively for clients of her firm." The *Avrahami* structure featured four insureds that paid premiums to Feedback and a risk pool, as described more fully below. The IRS challenged the deductions taken for all premiums.

The court engaged in a thorough review of the captive program, highlighting key facts and circumstances along the way, which would eventually form the basis of the court's holding that the captive, Feedback, did not qualify as insurance for federal tax purposes since it did not distribute risk or sell insurance in the commonly accepted sense.

The *Avrahami* Captive Structure and Key Facts

ACTUARIAL PRICING

Regarding the actuarial pricing, the court said that "an actuary typically starts with published rates and large datasets for particular risks and makes adjustments for policy limits, estimates of the frequency and severity of loss, deductibles, the claims history of a particular customer, and perhaps a dozen or so other factors that can be combined into equations that he uses to set a premium for a particular policy." The court observed that "the actuarial services that Feedback obtained were *somewhat different*."[10]

The court went on to cover how the actuary for the taxpayer, whom the court described as "something of a captive underwriter"[11] arrived at his premium amounts for every policy that was issued, including "loss of key employee," "litigation expense," and, what the court described as "the most peculiar policy of all," the "tax indemnity" policy.[12]

The court closely examined the actuary's approach to pricing the Avrahami policies. The actuary would start with public filings of large insurance companies, in this case, a Chubb filing from January of 2005. The actuary started with a base premium for each policy based on revenue and hazard group,[13] and then adjusted for various factors, such as whether the policy was claims-made[14] or occurrence based, the amount of deductible, an increase in limit, endorsement and coverage factor. Similar to expert reports involved with discounting family limited partnership interests, the court went through the numbers and identified occasions where the numbers did not add up[15] and focused carefully on the actuary's explanations.

The policies at issue were for administrative actions, business risk indemnity, business income, employee fidelity, litigation expense, loss of key employee, tax indemnity and of course, the terrorism coverage via the Pan American risk pool. While there was no objection as to whether the policy reflected "insurance risk," there was a question as to the pricing for each policy.

THE "TARGET"

The court then noted that the taxpayers had a "target." The target was a premium of $840,000 for the direct policies (where the captive directly insured the business) and $1.2 million in total. (The remaining $360,000 was to be paid to a risk pool to achieve risk distribution.) The court honed in on email communications where the actuary and Clark would review the premiums and changes would be necessary in order to have the premiums reach targeted amounts.[16] Thus, the actuary said he "dropped the limits as suggested." Afterwards, the policies would be drafted.

PAN AMERICAN RISK POOL

The court noted that the fronting company, Pan American, was owned by four shareholders, two of whom were Clark's children. The children "neither ever communicated with Pan American's management or the other shareholders about business matters."[17] Of the other two shareholders, one was a "courtesy director" who was needed because Nevis required someone with insurance experience. The last shareholder was the wife of the owner of the Feedback's management company (Heritor.) Heritor's sister company was Heritage Services, Ltd., and was the registered agent and insurance manager of the risk pool.

PAN AMERICAN: THE REINSURANCE STRUCTURE

The court examined Pan American and the reinsurance agreements, noting that purpose of the structure was meant to distribute risk. Pan American would "connect Clark's clients with other businesses that operate small insurance companies so they could spread their risk to each other by buying and reinsuring terrorism insurance."[18] The court focused on the details of the reinsurance structure using numbers:

> We'll use real numbers to show how this worked. Feedback decided to participate in Pan American's program in 2009 "at $360,000, calculated at 30% of [its] target premiums for 2009, which [was] $1.2 million." Under the Terrorism Risk Quota Share Reinsurance Agreement, it therefore agreed to a reinsurance premium of $360,000 in exchange for accepting 1.797% of Pan American's "Ultimate Total Loss for terrorism coverage to the insureds." In December 2009 American Findings paid Pan American $360,000—the same amount—for "Terrorism Risk Insurance" with a policy limit of $5,525,000 and coverage running from December 15, 2009, to December 15, 2010. Feedback, in turn, received three payments from Pan American—slightly more than $180,000 (50% of its reinsurance premium plus interest) in March 2010; slightly more than $171,000 (47.5% of its reinsurance premium plus interest) in June 2010; and slightly more than $9,000 (2.5% of its reinsurance premium plus interest) in December 2010. The same process repeated itself the next year--American Findings paid Pan American $360,000—this time for up to $5,125,000 of coverage—and Pan American paid Feedback $360,000 plus interest (50% in March 2011, 47.5% in June, and 2.5% in December).[19]

Thus, after the reinsurance premium was paid, Feedback would then receive the $360,000 premium back in three uneven (and frontloaded) installments. "The same process repeated itself the next year…" The court referred to the premiums received by the pool as being "cycled back" after 90 days and then after 180 days, with the last amount held back as a loss reserve until the policies expired on December 15. The explanation for the loss reserve was that Nevis law required reserves to be maintained on net premiums. If the pool were to have impaired solvency, it was permitted to issue promissory notes to an insured payable over a maximum of three years. According to both the taxpayer's and the Service's experts, this was a feature they never saw.

THE TERRORISM POLICY

The court described the terrorism policy (referred to as "TRIP," which stands for Terrorism Risk Insurance Pool) as being "designed to look a bit like the terrorism coverage required to be offered with certain commercial insurance products made available under [TRIA.]"[20] However, unlike TRIA coverage, TRIP included coverage for damage caused by the dispersion of biological or chemical agents, which is excluded under most – if not all – TRIA backed policies. Further, although TRIP excluded acts of terrorism "occurring in a city with more than 1.5 million residents," the term "city" was left undefined.

The court noted the Avrahamis were confused about the policy, finding that the Avrahamis felt the only amount at risk was the $360,000 each year, and "testified that it would 'be weird' to lose money and if Feedback did he would 'freak out.'"[21] In addition to the TRIP policy, the Avrahamis continued to buy add-on terrorism coverage – backed by the federal government in compliance with TRIA – from its commercial insurance provider.

FLOW OF FUNDS

The court noted the payment of significant premiums ($1,090,000 for 2009 and $1,170,000 for 2010) was coupled with a complete lack of claims on the part of the insureds (at least until the IRS audit started). This led to the creation of a surplus, the bulk of which was transferred to Mrs. Avrahami and a property owning partnership ("Belly Button") owned by the three children (even though the children had no knowledge of the partnership).

The court also noted how Belly Button continued to benefit from its connection to Feedback, receiving $1.5 million in 2010 as a loan, with a note executed by Mr. Avrahami on behalf of Belly Button payable to Feedback, followed by the transfer of $1.5 million from Belly Button's bank account into Mr. and Mrs. Avrahami's personal bank account. This happened more than once. With transfers such as these, the court noted that "insurance regulators often raise their bureaucratic eyebrows at related-party dealings like this."[22] Although Feedback did not receive approval from the insurance regulator in St. Kitts, "they should have" since St. Kitts requires prior written approval for loans to an affiliated person.

THE AUDIT

The court noted there had been no claims filed from inception until the time the audit began in 2012. The IRS informed the Avrahamis that one of the nonexclusive factors for determining whether a captive insurance company is a sham is whether any claims were filed with the captive; and if claims were filed, whether the validity of the claims was established before payments were made. Per the court, "this looks like it triggered something: By March 2013 the claims started rolling in from entities owned by the Avrahamis…"[23]

CLAIMS PROCESS

The claims process involved Clark determining whether a claim appeared to be covered, drafting a claim notification and preparing a sworn statement in proof of loss, and then sending everything to Heritor, (which could approve a claim). The Commissioner questioned whether some of the claims should have been approved by Heritor. The court took issue with the requirement that Feedback received notification of a claim within the policy period, yet Heritor granted extensions and approved claims filed in April of 2013 for policies that ended in December of 2012. The Business Risk policies required Feedback receive claim notification within the policy period. Yet, Heritor granted notification extensions and approved claims filed in April 2013 for policies that ended in December 15, 2012.

The Opinion

After a lengthy review of the background and pertinent facts, the court started its opinion with the general rules regarding the taxation of insurance, noting how some companies are exempt under § 501(c)(15) and some, that make an election under §831 (b), may exclude the premiums from income and be taxed only on taxable investment income.

When it came to the definition of insurance, the court then looked at four requirements developed over time based on numerous cases risk shifting, risk distribution, insurance risk and commonly accepted notions of insurance.

The court then proceeded to hone in on two particular requirements – risk distribution and insurance in the commonly accepted sense – both of which were found to be lacking, leading to a holding in favor of the Service.

MICROCAPTIVES

The court then set out to compare the characteristics of captives that have successfully attained insurance status in prior cases (citing *Harper*[24]and *Rent-A-Center*,[25] among others) and turned its focus specifically to the microcaptive.

Specifically, the court noted "in theory, a microcaptive could be run in the manner of the captives in *Rent-A-Center* or *Harper Group*, albeit on a much smaller scale." Importantly for microcaptives, the court acknowledged that a microcaptive can be an insurance company just as much larger ones, (such as those featured in *Rent-A-Center* and *Harper Group*).

But then the court pointed to how the captive could be abused – this is critical as many tax planners promote captives to accomplish purposes other than risk management. After acknowledging that microcaptives can be real insurance companies, the court observed, "But [the microcaptive] might also be run so that related parties pay the captive deductible insurance premiums of *just under* $1.2 million a year. In turn the captive might pay out few if any claims, might make a section 831(b) election so it pays tax only on its investment income, and might quickly build up its surplus."

The court then focused on circumstances that would suggest the captive was not being used for insurance purposes. Here, the court noted "if the captive were to be licensed and regulated in a jurisdiction with extremely low reserve requirements and loose rules on related-party transactions, it might lend its surplus back to its affiliates. This might generate nearly $1.2 million in tax deductions while arguably only moving money from one pocket to another."[26] The court honed in on the abuse of captives – while not holding that a low capital requirement would be fatal, the combination of a low capital requirement, loose regulatory requirements, etc., along with loans to affiliates, will raise a red flag.

The court considered other events that could transpire after building a surplus, such as making loans, or "perhaps the captive could be owned by a Roth IRA, which might mean it could make large dividend payments to its stockholder, creating a form of deductible, yet tax-free, retirement savings. Or purposes the captive could be owned by its business owner's children or an irrevocable family trust, which might enable the avoidance of future gift and estate taxes."[27] The court acknowledged that there could be variations on this theme, "none of which the Commissioner finds pleasing."[28]

The taxpayer believed all of the formalities were followed, and how everything complied with the Code and relevant case law. Premiums were actuarially determined and Feedback distributed risk by ensuring that at least 30 percent of its premium income came from unrelated parties participating in the pool. In other words, all was proper and everything was valid and documented. But the court demonstrated that it would not stop at aesthetics (to whatever degree such existed), it would also analyze the underlying facts and circumstances.

FACTS AND CIRCUMSTANCES

The question of whether a transaction constitutes insurance requires considering all the facts and circumstances, considering whether the arrangement involves risk shifting, risk distribution, insurance risk, and commonly accepted notions of insurance. The court started its analysis by focusing on risk distribution.

RISK DISTRIBUTION – BROTHER SISTER STRUCTURE

As for risk distribution in a brother sister context, where a sufficient number of related parties can permit a captive to qualify as insurance, the court turned to the experts. Although the Service's expert witness apparently did not address risk distribution in depth in his report, the court found the Service's expert did touch on risk distribution and the need for a sufficiently large number of risk exposures.[29] While the taxpayer's expert witnesses cited Revenue Ruling 2002-90 in concluding that seven policyholders should work; the court was not clear how taxpayer's expert derived a minimum of seven insureds. (It seems likely that the expert took the maximum concentration of risk (15 percent) allowable under Revenue Ruling 2002-90 and divided that number into one in order to produce the lowest number of insureds.)

Ultimately, the court ruled that it did not need to rely on any of the experts, as Feedback was insuring only *three* affiliated entities in 2009 and *four* in 2010. But importantly, the court did not rule that four affiliated entities (less than the seven policyholders mentioned by the taxpayer's expert) was fatal; instead, the court held that the true aim of the inquiry under the case law was not to focus solely on the number of policyholders, but to also "figure out the number of independent risk exposures." So here we see the court continue to look beyond the mere number of affiliated brother-sister entities, and also consider the number of independent risk exposures as well as the perspective from which risk distribution should be viewed.

EXPOSURE UNITS – A REQUIREMENT FOR INSURANCE COMPANIES

For a previous application of the concept of exposure units, the court looked at Rent A Center, where a sufficient number of statistically independent risks was present in an enterprise that had 14,000 employees, 7,100 vehicles, and 2,600 stores in all 50 states. The court also looked at *RVI*, where there were 714 different unrelated parties, but also because it issued 951 policies covering more than 750,000 vehicles. In *Humana Inc., v. Commisioner*[30] the court noted there were more than 20 corporations operating more than 60 hospitals with more than 8,500 beds.

Thus, for the insured, organizing the captive structure may entail consideration of the number of entities and a distribution of risk such that it complies with Revenue Ruling 2002-90. But under the common law as it continues to develop for the taxation of captive insurance, the court will look at risk distribution *from the viewpoint of the insurance company* – and in this case, the insurance company traditionally requires sufficient independent exposure units to be profitable (otherwise, it would not make good business sense to run an insurance company).[31]

Feedback issued seven direct policies to entities owned directly or indirectly by the Avrahamis, five to American Findings and two each to Chandler One, O&E, and White Knight. American Findings' policies covered three stores, two key employees and around 35 employees. The remaining policies covered three commercial real estate properties, all in metropolitan Phoenix.

But small business owners that utilize a microcaptive will necessarily fall short of the large amount of exposures faced by larger companies. The court considered the fact that it was dealing with a microcaptive, reasoning that the captive should not be required to have as many exposure units as the much larger captives in prior cases. Since Revenue Ruling 2002-90 provided a specific number of insureds, with the requirement that risk be spread among the set number of insureds (no less than five percent and no more than 15 percent per the insureds), one might have concluded that analyzing exposure units from the viewpoint of the captive was not required or even implicit in Revenue Ruling 2002-90.

The court did consider this, but ultimately felt that exposure units matter – even for microcaptives – and in this case, the number of exposure units were simply too small. "While we recognize that Feedback is a microcaptive and must operate on a smaller scale than the insurance companies in *RVI* or *Rent-A-Center*, we can't find that it covered a sufficient number of risk exposures to achieve risk distribution merely through its affiliated entities." Consequently, it remains to be seen what magnitude of exposure is required in the context of a microcaptive.

RISK DISTRIBUTION VIA THIRD PARTY RISK

But given the small number of insureds in *Avrahami*, many believed the brother-sister argument was more of a reach (after all, there weren't even seven, let alone 12, related entities), and the strength of the structure primarily rested on the use of third party risk via risk pool.

Regarding the presence of third party risk, the court noted that Feedback distributed risk by participating in the Pan American program and reinsuring third-party risk. "[Taxpayers] stress that we found risk distribution in two prior cases by looking at the percentage of the captive's gross premium income received from unrelated insureds."[32] In this situation, the taxpayers cited *AMERCO Subs., v Commissioner*,[33] where "outside insurance constituted over 50 percent of [the captive's] gross written premiums"[34] and in *Harper Group*, where at least 29 percent of the captive's gross premium revenue came from unrelated parties. Here, Feedback ceded 30 percent risk and assumed 30 percent risk from the terrorism risk pool; 30 percent is greater than 29 percent (the floor in *Harper Group*), so it was natural to assume that third party risk was achieved.

BONA FIDE INSURANCE COMPANY

The court required Pan American, the fronting insurance company for the risk pool program, to be a bona fide insurance company itself, before the court could possibly rule whether Feedback distributed risk through the pool. "[B]efore we can say whether Feedback distributed risk through the Pan American program, we must decide if Pan American itself was a bona fide insurance company."[35] For this exercise, the court enumerated nine relevant factors, but focused on three factors, (1) circular flow of funds, (2) unreasonable premiums and (3) arm's-length contracts.

CIRCULAR FLOW OF FUNDS

The court started with an analysis of the nature of the program; viewed from afar, the risk pool was essentially a temporary whirlpool, with funds that entered cycling quickly through and back out on a set payment schedule. The court's perception was that it "looks suspiciously like a circular flow of funds."[36] The end result in two years was to transfer $720,000 owned by the Avrahamis to an entity owned 100 percent by Mrs. Avrahami (so not a perfect circle, but close enough).

UNREASONABLE PREMIUMS

The court also found the premiums to be unreasonable. Although terrorism is an insurable risk, the Service and the taxpayer disagreed on the reasonableness of the terms and the premiums. The court noted that the actuary – hired by Clark – recommended a rate on line between five percent and eight percent of the policy limit in 2009 and between five percent and nine percent in 2010.[37] Rates were the same across the board regardless of geographic location. Pan

American participants paid the same rate even if they – like American Findings – had primary terrorism coverage under another policy.

In contrast, the rate on line for a commercial terrorism policy was around 0.081 percent. The Avrahami actuary justified the difference because the TRIP policy included chemical and biological attacks.[38] The court acknowledged the need for premium adjustment for the additional coverage but questioned why the premium was not reduced due to some of the TRIP exclusions, such as attacks occurring in any city with more than 1.5 million residents[39] or payments to insureds via promissory notes.

Regarding the overall pricing of the premiums for the policies, the court found the actuary's explanations to be "often incomprehensible"[40] and also noted that he priced captives only for Clark. Not only did the actuary's explanations lack persuasion, the court found the premiums to be "utterly unreasonable."[41] Part of this conclusion rested on the fact that the Avrahami's spent $150,000 on insurance before the captive, and then in excess of $1.1 million in 2009 and more than $1.3 million in 2010. While the Avrahamis were paying approximately $1.2 million per year for the captive insurance, they maintained their commercial coverage for less than $90,000 per year. Notably, the actuary's process for determining premiums routinely involved inputs that generated higher premiums.

ARMS-LENGTH CONTRACTS

Finally, the court found that some of the contracts involved were so unusual that no business owner would enter into them in the absence of tax benefits. With the amounts paid for the terrorism coverage, the hurdle of actually receiving a payment for a loss seemed too high – high enough to lead the Service's expert to conclude that "he did not know of any event in history that would have met these requirements." Furthermore, the court questioned whether a payment could actually be made, based on the financial health of the risk pool.

NO THIRD PARTY RISK DUE TO LACK OF BONA FIDE INSURANCE COMPANY

Although Pan American met the minimum capitalization requirements under Nevis law, the court would "not pretend that a company as thinly capitalized as Pan American, with directors and a management team substantially weaker in numbers and ability than those of a normal reinsurer, would be hard pressed to enforce the cession agreements against the scores of captive insurers it might have to go after."

On top of these factors, the court looked at the way Pan American made money off the reinsurance transactions and found Pan American's fee structure to be atypical.[42] When adding up all of the factors, the court held the Pan American pooling program was not a bona fide insurance company. Consequently, Feedback did not obtain risk distribution through its participation in the Pan American pool – and since Feedback already lost on the "number of policyholders" theory of distribution; it lacked risk distribution, which is an essential ingredient for insurance.

Insurance in the Commonly Accepted Sense

The court noted that the absence of risk distribution was "enough to sink Feedback." However, the court provided its analysis with respect to whether the program looked like insurance in the commonly accepted sense. The court acknowledged that this requirement is an "alternative ground" and in doing so, the relevant factors include (1) whether a company is organized, operated and regulated as an insurance company, (2) whether the policies were valid and binding, (3) whether the premiums were reasonable and the result of an arm's length transaction, and (4) whether claims were paid. The court said it could also consider whether the policies "covered typical insurance risks" and whether "there was a legitimate business reason for acquiring insurance from the captive."[43] Based on the facts presented, the court concluded Feedback's operations "left something to be desired," citing the lack of claims (until the audit began), questionable investments, lack of clarity with insurance policies and unreasonable premiums.

Conclusion

For some microcaptives, *Avrahami* demonstrates the importance of adhering to the formalities, but it also demonstrates the importance of the captive process being driven by risk management needs, as opposed to tax minimization. Evaluating whether a structure makes business sense from multiple vantage points (insured, reinsurer, etc.) would almost certainly strengthen the insurance program. Many of these issues can be dealt with in the very beginning with a proper feasibility study, which can provide a blueprint of how insurance needs should be handled for the particular business owner, which may not include the use of a captive. It cannot be stressed enough that the genesis of the captive decision-making process will be one of the most important factors considered by the court because it establishes the bona fides of the captive and consequently, as demonstrated in prior cases with large captives, sets the tone for the court's analysis.[44] In other words, with captives (as in life), a first impression is a lasting one.

Next Steps

While *Avrahami* can be viewed as limited solely to microcaptives with facts similar to the structure at issue, certain elements of the opinion may have an impact on others. For instance, business owners that are currently in microcaptive arrangements (or prospective purchasers of such a business) may consider having their program reviewed by an independent advisor or actuary to ascertain whether the issues in *Avrahami* could impact their current structure. Business owners that are currently in audit would especially be interested in determining the strengths and weaknesses of their program in light of the Tax Court's view on risk distribution[45] and commonly accepted notions of insurance. Captive managers may review this opinion and compare the shortfalls of the Pan American program with their own risk pooling structure, honing in on nuances that might strengthen various positions in IRS audit.

For those who are considering exiting a captive, numerous issues must be considered, including the form of exit (e.g., liquidation), termination documentation necessary to exit the captive,[46] and the tax consequences of closing the captive. Further, more opinions will be forthcoming that involve variations on the microcaptive structure, including, for example, different structures and (hopefully) better facts.

Endnotes

[1]. *See Helvering v. Le Gierse*, 312 U.S. 531 (1941).

[2]. *See Avrahami v. Commissioner*, No. 17594-13, 2017 WL 3610601 (T.C. Aug. 21, 2017).

[3]. *Le Gierse* at 537, 540. ("The 'insurance' policy would not have been issued without the annuity contract, but in all formal respects the two were treated as distinct transactions. *** The two contracts must be considered together. To say they are distinct transactions is to ignore actuality, for it is conceded on all sides and was found as a fact by the Board of Tax Appeals that the 'insurance' policy would not have been issued without the annuity contract.")

[4]. *Avrahami* at 19. ("In turn the captive might pay out few if any claims, might make a section 831(b) election so it pays tax only on its investment income, and might quickly build up a large surplus. [P]erhaps the captive could be owned by its business owner's children or an irrevocable family trust, which might enable the avoidance of future gift and estate taxes.")

[5]. *Id.* at 17. ("[A] tax break for qualifying insurance companies is not a new idea. The Revenue Act of 1924, ch. 234, sec 231 (10), 43 Stat. at 283, exempted certain mutual-insurance companies from tax if 85% or more of their income was collected "for the sole purpose of meeting losses and expense.")

[6]. *See* Paul Sullivan, *I.R.S. Is Looking Into Captive Insurance Shelters*, April 10, 2015, available at https://www.nytimes.com/2015/04/11/your-money/irs-is-looking-into-captive-insurance-shelters.html?mcubz=0.

[7]. Query whether this was the fair result given the ultimate denial of insurance status to the controlled foreign corporation, and whether the $200,000 could have been treated as a return of capital.

[8]. *Avrahami* at 2. ("By 2007 the Avrahami entities were flourishing and the Avrahamis were in need of some advice. They turned to Craig McEntee, who had been their trusted CPA for about 25 years.")

[9]. An election to be treated as a United States corporation.

[10]. *Id.* at 5.

[11]. The actuary, Allen Rosenbach, testified "that in 2009 and 2010 he prepared premium estimates for more than 50 but fewer than 80 captives. Most, if not all, were Clark's clients."

[12]. The court found the actuary's assumptions regarding the tax indemnity policy to be "murky."

[13]. Although the actuary stated one of the Avrahami insureds was a "property manager" that fell into hazard group 4, the court noted the January 2005 Chubb filing actually classified property managers into category 2, not 4.

[14]. *Avrahami* at 6. ("Claims-made policies are '[a]n agreement to indemnify against all claims made during a specified period, regardless of when the incidents that gave rise to the claims occurred.' *** Claims-made policies are often contrasted with occurrence policies, which are '[a]n agreement to indemnify for any loss from an event that occurs within the policy period, regardless of when the claim is made.'")

[15]. *Id.* at 8. The court reviewed the actuarial computations on a policy by policy basis, expressing confusion at several points. ("The reason for these changes is not clear from the record," "[t]he reason for these differences is not clear from the record," "[t]he exact calculation of the $71,000 is not clear from the record," etc.)

[16]. *Id.* at 10 ("The email back from Clark says: 'it looks like we're still pretty far even with 10 months prorated for the old policies. I think we should go back to full years for all the policies with $840,000 as the target.'")

[17]. *Id.* at 11.

[18]. *Id.* at 11.

[19]. *Id.* at 12.

[20]. *Id.* at 12. One of the Terrorism Risk Insurance Act's ("TRIA's") purposes was to provide a federal backstop for acts of terrorism. See Circular Letter 2015-2, 2015 WL 770190 (NY INS BUL). ("In the wake of the September 11, 2001 attacks, Congress enacted TRIA and the President signed it into law in November 2002. This federal law provided a federal backstop for defined

acts of terrorism and imposed certain obligations on insurers. In 2005, the Act was extended for a two-year period by the Terrorism Risk Insurance Extension Act of 2005, and it was extended for an additional seven years, through December 31, 2014, with the enactment of the Terrorism Risk Insurance Program Reauthorization Act of 2007. TRIA has now been extended again, for six years, with the enactment of the Terrorism Risk Insurance Program Reauthorization Act of 2015.")

[21]. *Id.* See footnote 33.

[22]. *Id.* at 15.

[23]. *Id.* at 16.

[24]. *Harper Grp. v. Commissioner*, 96 T.C. 45 (1991), aff'd, 979 F 2d 1341 (9th Cir. 1992).

[25]. *Rent-A-Center, Inc. v. Commissioner*, 142 T.C. 1 (2014).

[26]. *Id.* at 19.

[27]. *Id.*

[28]. *Id.*

[29]. *Id.* at 21.

[30]. *Humana Inc. v. Commissioner*, 881 F.2d 247 (6th Cir. 1989).

[31]. *See R.V.I. Guar. Co. & Subsidiaries v. C.I.R.*, 145 T.C. 209, 228 (2015). ("From the insurer's perspective, insurance is a risk-distribution device, that is, a mechanism by which the insurer pools multiple risks of multiple insureds in order to take advantage of "the law of large numbers." *** RVIA insured a vast array of different risk exposures. During 2006 it had 951 policies in force covering 714 different insured parties. Besides being spread among numerous unrelated insureds, its risks were distributed in at least four ways: across business segments (passenger vehicle, commercial equipment, and real estate), across asset types within each segment, across geographic locations (for real estate), and across lease duration.") (Emphasis added.)

[32]. *Id.* at 65.

[33]. 96 T.C. 18 (1991), *aff'd*, 979 F. 2d 162 (9th Cir. 1992).

[34]. *Id.* at 22.

[35]. *Id.*

[36]. *Id.* at 23.

[37]. A "rate on line" is the ratio of the premium paid to the policy limit.

[38]. According to the Insurance Information Institute, nuclear, biological chemical and radiological attacks are excluded in most cases. "Depending on your state, a terrorism insurance policy may exclude coverage for fire following. Nuclear, biological, chemical and radiological (NBCR) attacks are also excluded, except in the life, health and workers compensation lines of insurance." Information retrieved from http://www.iii.org/article/does-my-business-need-terrorism-insurance.

[39]. There are two problems with the exclusion of coverage for terrorist activities in a city of 1.5 million or more residents. First, it can probably safely be assumed that a significant portion of terrorist attacks will take place in cities with a population of more than 1.5 million (e.g., the terrorist attacks on the Twin Towers on September 11, 2001). This limitation should accordingly significantly reduce the cost of coverage. Second, the population of Phoenix in the 2009 and 2010 time frame was very close to 1.5 million, and if the number had increased above 1.5 million at any point, some or all of the coverage would have been lost.

[40]. *Id.* at 27.

[41]. *Id.*

[42]. There was some discussion as to the lack of a security mechanism regarding the obligation of insureds under the reinsurance agreement, as the court noted the "questionable ability to pay claims" and "if a reinsurer wouldn't or couldn't pay, Pan American would have to foot the bill itself…" "A fronting company, while not taking on any insurance risk, still must be compensated for the services it provides, including the assumption of credit risk -- the risk that the reinsurers can't or won't pay their portion of an insured loss, forcing the fronting company to come up with the money to settle a claim." *Id.* at 25.

[43]. These factors may also be relevant in subsequent controversies where the Service alleges a lack of economic substance.

[44]. *See Rent-A-Ctr., Inc. v. C.I.R.*, 142 T.C. 1, 11 (2014). ("After successfully resolving petitioner's D & O insurance problem, Aon evaluated petitioner's risk management department. Petitioner, with Aon's assistance, improved risk management practices, switched from bundled to unbundled policies, and hired SRS as a third-party administrator. Aon proposed that petitioner form a captive, and petitioner determined that a captive would allow it to reduce its insurance costs, obtain otherwise unavailable insurance coverage, formalize and more efficiently manage its insurance program, and provide accountability and transparency relating to insurance costs. Petitioner engaged KPMG to prepare financial projections and evaluate tax considerations referenced in the feasibility study. Federal income tax consequences were considered, but the formation of Legacy was not a tax-driven transaction. *See Moline Props., Inc. v. Commissioner*, 319 U.S. at 439; *Britt v. United States*, 431 F.2d 227, 235–236 (5th Cir.1970); *Bass v. Commissioner*, 50 T.C. 595, 600, 1968 WL 1442 (1968). To the contrary, in forming Legacy, petitioner made a business decision premised on a myriad of significant and legitimate nontax considerations. *See Jones v. Commissioner*, 64 T.C. 1066, 1076, 1975 WL 3065 (1975) ("A corporation is not a 'sham' if it was organized for legitimate business purposes or if it engages in a substantial business activity."); *Bass v. Commissioner*, 50 T.C. at 600.")

[45]. For example, it may be that the opinion strengthens the negotiating power for large businesses utilizing a microcaptive with considerably more exposure units than what was present with Feedback.

[46]. Any proposed termination documentation should be carefully reviewed to consider additional exposure to the business owner and potential loss of legal rights. Such loss of rights could include the ability to bring claims against certain parties or participation in a class action (e.g., http://lfdslaw.com/captive-insurance-tax-schemes/).

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