TECHNICAL MEMORANDUM

US Tax Court Opinion: Avrahami v. Commissioner

By: Jeffrey I. Bleiweis

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RMC GROUP

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Avrahami v. Commissioner

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TECHNICAL MEMORANDUM

TO: Raymond G. Ankner, President

FROM: Jeffrey I. Bleiweis, Vice President and General Counsel

RE: US Tax Court Opinion - Avrahami v. Commissioner

DATE: August 25, 2017

On August 21, 2017, the Tax Court released its eagerly-awaited opinion in the consolidated cases, *Benyamin Avrahami and Orna Avrahami v. Commissioner* and *Feedback Insurance Company, Ltd. v. Commissioner*; the first court case involving a so-called "micro-captive transaction". The decision was a mixed-bag. While the Petitioners lost on almost every issue, the Court's decision was very much fact-specific. So, it is not clear what this case means for micro-captive transactions with different facts.

In many ways, the micro-captive transaction in this case was typical of the industry. The Avrahamis were successful business people who owned a number of jewelry stores, as well as real estate. At some point, they were approached by financial consultants who advised them that they could provide insurance for their businesses through a captive insurance company. So, they formed Feedback in St. Kitts. Feedback sold a number of property and casualty insurance policies to certain of the entities owned by the Avrahamis, covering administrative actions, business risk indemnity, loss of business income as a result of reputational damage or new competition, employee fidelity, litigation expense, loss of key employee and tax indemnity. Feedback retained an actuary, who calculated the premiums for each policy. In addition, Feedback made elections under sections 953(d) and 831(b) of the Internal Revenue Code.

While the structure of Feedback was similar to other captives in the industry, in one very important way it was very different. In addition to the policies issued by Feedback, the Avrahamis also purchased terrorism risk insurance policies from an insurance company called Pan-American

Reinsurance Company, Ltd., another St. Kitts company, the ownership of which was totally unrelated to the Avrahamis. As far as we know, terrorism risk insurance was the only type of policy offered by Pan American, and it was offered only to those entities participating in a particular captive insurance program. Most importantly, the Court determined that the policy was crafted in such a manner that it was highly unlikely that a claim could ever be asserted under the policy.

The Avrahamis' business entities were a combination of s-corporations and partnerships, so the deductions for insurance premiums paid to Feedback and Pan American flowed to their personal tax returns. Eventually, the Avrahamis were audited, and their deductions were denied. Upon issuance of a Notice of Deficiency, the Avrahamis filed these cases in the Tax Court.

The Court began its analysis by confirming what we all know to be true:

> Amounts paid for insurance are deductible under section 162(a) as ordinary and necessary expenses paid or incurred in connection with a trade or business. Sec. 1.162-1(a) Income Tax Regs.

It further stated that neither the Code, nor the treasury regulations, defines the term insurance. Instead, we must rely on case law, which has, over a number of years, developed a definition of insurance.

The Court then set forth the common law definition of insurance, which was first established by the Supreme Court in the case, *Helvering v. Le Gierse*, 312 U.S. 531,539 (1941). In that case, the Supreme Court said that, in order for an arrangement to be considered insurance, it must have the following characteristics:

- involve risk shifting;
- involve risk distribution;
- involve insurance risk; and
- meet commonly accepted notions of insurance.

So far, so good, and nothing very surprising. The Court then got to the real issue in this case – "Were the policies issued by Feedback and Pan American contracts for insurance?"

The Court first looked to whether the arrangement provided for "risk distribution", which it defined as the law of large numbers. By assuming a large number of independent and randomlyoccurring risks, an insurance company "smoothes out losses to match more closely its receipt of premiums".

The Avrahamis advanced two arguments to establish "risk distribution". The first argument was based on the fact that insurance was provided to a number of different related entities. It is not clear why the Avrahamis made this argument. It should have been clear from the start that it was a loser. The problem is that the number of related entities that purchased insurance from Feedback was no more than 3 or 4, which under any analysis of the issue is too few.

In dealing with this argument, the Court reviewed the cases in which it had previously upheld arrangements where a captive provided insurance exclusively to related entities and made an astounding statement. It said that it was not the number of affiliated entities that mattered, but the number of "statistically independent risks" that were insured. In cases with which we are all familiar, such as *Rent-A-Center*, *R.V.I.* and *Securitas*, the Court said that the captives had insured thousands, if not hundreds of thousands, of independent risks, and that is why the courts in those cases had found that the arrangements constituted insurance.

The Court's statement is astounding for two reasons. The first is that the Court seems to be imposing an obligation on a micro-captive that a micro-captive, by definition, can never satisfy. For the tax years in question, the premium limitation under section 831(b) was \$1.2m. It is difficult to see how a micro-captive could insure hundreds of thousands of independent risks and keep its total premiums under \$1.2m. Remember, *Rent-A-Center*, *R.V.I.* and *Securitas* did not involve micro-captives. The second reason is that the Court seems to have ignored Rev. Rul. 2002-90. In the revenue ruling, the IRS specifically said that a brother-sister arrangement with 12 related entities would provide the necessary "risk distribution" for an arrangement to constitute insurance. The IRS said nothing about the number of independent risks. Yet, the Court in Avrahami completely disregarded the position set forth by the IRS in the revenue ruling and said that:

> We also want to emphasize that it isn't just the *number* of brother-sister entities that one should look at in deciding whether an arrangement is distributing risk.

Of course, even if the Court had correctly applied the standard set forth in the revenue ruling, the Avrahamis' argument would have failed, because they only had 3 or 4 related entities, not 12.

The second argument advanced by the Avrahamis to establish "risk distribution" was based on the terrorism risk insurance policy issued by Pan American. As noted above, Pan American issued the same policy to every entity participating in its captive insurance program. Pan American then reinsured these policies with the captives, thus distributing the terrorism risk assumed by Pan American among the many captives participating in the program. The result was that each captive, including Feedback, received at least 30% of its premiums and risk exposure from unrelated parties.

Before we discuss the Court's response to the Avrahamis' argument, it is worth noting that the Avrahamis' argument was very aggressive. There is a court case that seems to say that "risk distribution" exists as long as a captive gets 30% of its premiums and risk exposure from unrelated entities. However, the IRS has never acceded to the 30% figure. In Rev. Rul. 2002-89, the IRS used 50% as the threshold number. Of course, the Court also ignored Rev. Rul. 2002-89 and rejected the Avrahamis' argument on other grounds.

The Court said that the Pan American reinsurance arrangement can accomplish the requisite "risk distribution" only if Pan American itself is a "*bona fide* insurance company". The Court then listed nine factors that are commonly taken into account when deciding whether an entity is an insurance company. While the Court listed nine factors, it only considered four in deciding that Pan American is not a *bona fide* insurance company.

First, the Court pointed to what it called "the circular flow of funds". The Avrahamis paid premiums to Pan American, and Pan American paid the same amount to Feedback as reinsurance premiums. "While not a complete loop, this arrangement looks suspiciously like a circular flow of funds." (p. 68). The Court does not explain why this is a problem. However, it was an important factor in its determination that Pan American was not a *bona fide* insurance company.

Second, the Court found that the premiums charged by Pan American were "grossly excessive". This was a finding of fact made by the Court based on expert witness testimony presented by the parties. The only lesson to be learned is that a captive's actuary must be able to justify the premiums charged by the captive.

Third, the Court found that the insurance contracts were not the result of an "arms-length transaction". This finding was based, in part, on the fact that Pan American's terrorism risk insurance policy was unlikely to ever pay a claim. The policy was an excess policy, which is not necessarily a problem. However, the policy was excess over an amount that would never be reached. The Avrahamis' own actuary testified that "he did not know of any event in history that would have met these requirements". The fact that an insured was required to pay excessive premiums for a policy that would never pay a claim led the Court to conclude that no reasonable business person would purchase the Pan American terrorism risk insurance policy but for the tax benefits.

Finally, the Court considered whether Pan American should be treated as a fronting company instead of a direct insurer. The Court acknowledged that even the IRS conceded that a fronting company is a "real thing". However, the Court also said that Pan American was not a fronting company because it did not charge a ceding fee as a percentage of premiums paid. Instead, it charged a flat fee, irrespective of the amount of risk assumed and then ceded by Pan American. The Court said that this was insufficient to ensure that Pan American would be able to pay claims in the event that any of its reinsurers did not. As a result, Pan American could not be treated as a fronting company.

As a result of the foregoing factors, the Court said that:

> Because we find that Pan American was not a *bona fide* insurance company, we cannot find that the policies it was issuing were insurance, which in turn means Feedback's reinsurance of those same policies did not distribute risk.

The Court could have stopped there, because "(t)he absence of risk distribution by itself is enough to sink Feedback". However, it did not. It went on to say that "in deciding whether an arrangement is insurance we can also look at whether it *looks* like insurance in the commonly accepted sense". The Court then considered a number of factors in determining that the arrangement was not insurance in the commonly accepted sense.

1. Organization, Operation and Regulation

The Court acknowledged that Feedback was organized under the laws of St. Kitts and that it was subject to regulation by the insurance department of St. Kitts. The IRS argued that Feedback was also subject to regulation by Arizona and that it was in violation of the Arizona insurance regulations. The Court said that it did not need to decide this issue, because the real question is whether Feedback was <u>operated</u> as an "insurance company". The Court found that it was not for two reasons.

The first reason is that Feedback did not have a consistent claims procedure. Instead, it dealt with claims on an "ad-hoc" basis. Claims were approved despite having been filed late and without the necessary documentation. A real insurance company would not be operated in this manner.

The second, and perhaps most important, reason is that Feedback made improper investment decisions. Most of its assets were held in the form of long-term loans to shareholders. Without regard to whether the loans were properly documented or even whether the shareholders had the financial ability to repay the loans, the Court noted that such loans were illiquid. They were not due for many years in the future. It was hard to see how Feedback would have the ability to pay claims. As a result, the Court found that "(e)ven if Feedback was organized and regulated as an insurance company, we find it was not operated like one".

2. Capitalization

This is one piece of good news in the Court's opinion. The parties acknowledged that Feedback met the capitalization requirements of St. Kitts. The IRS claimed that this was not enough. The Court disagreed. It said that case law clearly holds that an insurance company is adequately capitalized when it meets the requirements of its regulators.

3. Valid and Binding Policies

While the interpretation of a contract, including an insurance contract, is generally a matter of law, the Court treated this issue as a question of fact. And, the issue was whether the insurance policies imposed a legally enforceable obligation on the insurance company to pay claims under certain identifiable circumstances. The Court found that the Feedback policies did not. The policies were poorly written and confusing. They could be read as both a claims-made policy and an occurrence policy. The covered events were not adequately described. As a result, this factor worked against finding that Feedback was insurance in the commonly accepted sense. Of course, it should be noted that the Court's finding was fact specific. Where a policy is well-written and clearly identifies the insured occurrence, a court should have no trouble finding it to be a valid and binding policy.

4. Reasonableness of Premiums

The Court found that the premiums charged by both Feedback and Pan American were unreasonable. This was a finding of fact based on the expert witness testimony presented by both sides. It is very much fact-specific. Furthermore, the Court simply found that the premiums were unreasonable. It did not articulate a test that can be used in other cases. As a result, the Court's opinion provides no guidance on the issue of reasonableness of premiums.

5. Payment of Claims

The Court looked at whether Feedback paid claims. The Court found that it had. While this factor works in favor of finding that Feedback was an insurance company, the Court noted and found problematic that no claims had been submitted to Feedback until after the IRS began its audit of the Avrahamis and Feedback.

After taking the foregoing factors into consideration, the Court found that the arrangement was not insurance in the commonly accepted sense.

> Although Feedback was organized and regulated as an insurance company, paid the claims filed against it, and met the minimal capitalization requirements of St. Kitts, these insurance-like traits cannot overcome its other failings. It was not operated like an insurance company, it issued policies with unclear and contradictory terms, and it charged wholly unreasonable premiums.

Obviously, the result in the Avrahami case is bad news for the Avrahamis and Feedback. However, because it is so fact-specific, it is difficult to know the impact on other captives with different facts. In addition, the IRS did not get everything that it wanted. Because it was sufficient that the Court found a lack of "risk distribution", the Court did not consider whether there was "risk shifting"; even though it did discuss whether the arrangement was "insurance in its commonly accepted sense" and there was no need for the Court to consider that issue. Since the Court only discussed those areas where it held against the taxpayer, it may be possible to assume that the Court would have found that there was "risk shifting". In addition, the Court did not discuss whether the arrangement involved insurance risk. The IRS clearly wanted the Court to find that the policies issued by Feedback did not cover "insurable risks". But, it refused. This issue remains for another day. The IRS also wanted a decision on the issues of economic substance, form-over-substance and step transaction. Again, the Court refused to consider those issues. Finally, the Court abated most of the penalties assessed against the taxpayers in large part because this was a case of first impression. Of course, only one case can be a case of first impression. So, if any future taxpayer wants to avoid penalties, it is imperative that the taxpayer consult with independent and competent legal and tax advisors, who have full knowledge of the facts of the arrangement, before entering into the arrangement.

RESOURCES

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Jeff joined CJA & Associates, a member of the RMC Group, in 1993 and currently serves as Vice President and General Counsel. He advises senior management on legal and tax issues related to the design and administration of insurance products, employee benefit plans, and risk management services.

Mr. Bleiweis frequently speaks before professional groups on the use of insurance products in qualified and non-qualified employee benefit plans. He has addressed meetings of accountants, financial planners, and insurance professionals across the country. He advises a nationwide network of independent insurance agents on tax and ERISA issues and has written extensively in the course of that work. He has published several articles on employee benefit plan issues. He has also testified before the Internal Revenue Service.

Mr. Bleiweis currently resides in Winnetka, Illinois, with his wife and two children.

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www.cicaworld.com/Resources.aspx

Self-Insurance Institute of America (SIIA):
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The Risk Management Society (RIMS):
www.rims.org/resources/ERM/Pages/default.aspx

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