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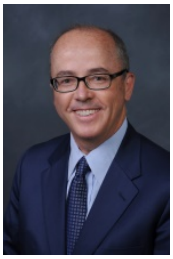

A CAPTIVE MUST ACT LIKE AN INSURER

By: Timothy M. Thornton, Jr., Gray•Duffy, LLP, Encino

In *Avrahami v. Commissioner, U.S. Tax Ct.*, Aug. 21. 2017, 149 F.C. No. 7, the Avrahamis incorporated a captive insurer, Feedback Insurance Company, Ltd. Feedback elected to be treated as a domestic corporation, and to be taxed as a small insurance company, IRC 831(b). After Feedback was organized, premiums deducted by the Avrahamis increased significantly.

First, Feedback sold "direct" policies (business income, employee fidelity, litigation expense, key employee, tax indemnity, administrative action, and business risk indemnity) to Avrahami entities. Those entities continued to purchase more typical coverage – business owners and jewelers block, etc. – from commercial insurers.

Second, Feedback and the Avrahami entities participated in a risk distribution program through Pan American Reinsurance which offered terrorism insurance. In this transaction Avrahami entities paid premiums to Pan American; which reinsured these policies with captives, including Feedback, pursuant to a Terrorism Risk Quota Share Reinsurance Agreement. The premiums were returned to the captives over the policy year. This coverage was considerably more expensive than TRIA coverage.

The Commissioner argued that Feedback's policies were not "insurance", and therefore the premiums were not deductible as business expense. The term "insurance" is not defined in the statute or regulations. Case law holds that insurance must involve risk-shifting, risk-distribution, and insurance risk, and must meet "commonly accepted notions of insurance". These factors apply to all insurance, and as well to captive and to microcaptive insurance.

A pure captive is one that insures only risks of companies related to it by ownership. Combining the concept of captive insurance with section 831(b) tax advantages for small insurance companies results in a "microcaptive." An insurer generally pays tax on premium received and other income. But under section 831(b), a small insurer – or a microcaptive – pays tax not on premium received, but on investment income.

(At that time, an insurer was exempt from tax under IRC 501(c)(15) if gross receipts for the tax year did not exceed $600,000, and more than 50 percent was premiums. If over that and under a "premium ceiling" of $1.2 million, it could elect to be taxed under IRC 831(b). In 2015 the premium ceiling was increased to $2.2 million with new diversification agreements. This different tax treatment appears to be the significant distinction between a microcaptive and a captive.)

Feedback hired an actuary. The court found that the actuary priced captives only for this promoter, that his explanations were often incomprehensible, and the actuary was not persuasive. The court found the premiums were "utterly unreasonable". The promoter advised the actuary of the Avrahami's "target premium". The promoter and actuary then backed in to these figures. The 30% reinsured with Pan

American was an attempt to come within case law holding that 30% of total premiums received by an insurer was a "significant portion" of the risk, to satisfy the "risk distribution" factor.

The court here focused on two of the factors: risk distribution and "commonly accepted notions of insurance."

Feedback's direct policies did not cover a sufficient number of risk exposures to achieve risk distribution. Thus Feedback had to rely on the Pan American program. The court found Pan American had an atypical fee structure, excessive premiums, an ultralow probability of a claim ever being paid, and payments of a circular nature.

Here the dominoes begin to fall. The court held Pan American was not a bona fide insurer, its policies were not "insurance." Therefore, Feedback's reinsurance did not "distribute risk." Therefore, Feedback was not an insurer. So its policies were not insurance.

The court also considered the "insurance in the commonly accepted sense" issue.

The court held that Feedback was not operated like an insurer, its policies were unclear and contradictory and it charged unreasonable premiums. (Feedback did not receive any claims until the IRS began its audit. Then claims were paid under claims-made coverage even though late, and one property loss was paid without determination of the cause of loss.) This was not insurance in the commonly accepted sense.

Since the Feedback policies were not insurance, the premiums were not deductible business expenses for the Avrahami entities.

While Feedback was a microcaptive, the issue of whether its contracts were "insurance" and whether it was an "insurer" are issues that apply as well to all captives. The holdings here are important for large captives as well. They must be able to demonstrate risk-shifting, risk-distribution, and insurance risk, and must meet "commonly accepted notions of insurance." There should be claims and not just when the IRS begins its audit. And related party transactions are best avoided, or very carefully done. Those transactions may affect the legal determination, and certainly would seem to affect a court's view of arrangement. Lastly, the court raised and did not decide an important issue: did the insurance law and regulation of the insured's domicile (here Arizona) also apply and were those laws and regulations satisfied?

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