# MICRO-CAPTIVE INSURERS: THE TAX COURT DISALLOWS DEDUCTIONS FOLLOWING TRIAL

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Micro-captive insurance schemes have caught the attention of the IRS; last year it issued a notice indicating that these arrangements have a potential for tax avoidance or evasion and designating them as transactions of interest. Notice 2016-66, 2016-47 I.R.B. 745. In a micro-captive structure, a business owner sets up an affiliated insurance company; the tax structure then works as follows:

- The business pays premiums to the related party insurer, and it claims a business expense deduction on the premiums;
- If the insurer limits its premium income, it can qualify to pay tax only on its investment income, not on the premiums that it receives by making an election under section 831(b) of the Internal Revenue Code;
- The premiums accumulate creating a pool to pay claims; over time, the business may be able to reduce or eliminate its existing commercial coverage.

These arrangements, however, are subject to potential abuse because of the involvement of related parties: If premiums are set at excessively high levels, a significant amount of income can be sheltered, which is why the IRS issued the notice. As an example, a district court opinion issued earlier this year noted an arrangement where a dentist paid $8,000 per month in premiums to a micro-captive for an excess malpractice policy; his primary policy cost $1,400 *annually*. *Omega Forex Grp. L.C. v. United States,* No. 2:14-CV-00915-BSJ, 2017 U.S. Dist. LEXIS 33289, *5 & n.17 (D. Utah Mar. 18, 2017). Policies for exotic risks, such as terrorism insurance, are also apparently popular.

Last week, the Tax Court issued an opinion following its first trial involving a micro-captive insurer. *Avrahami v. Comm'r*, Nos. 17594-13 & 18274-13, 2017 U.S. Tax Ct. LEXIS 40 (Aug. 21, 2017). The court's ruling suggests that taxpayers who have entered into these arrangements will have an uphill battle sustaining them, even in situations that do not appear to be abusive.

The Avrahamis were successful business people who started in the jewelry industry and branched out into commercial real estate. *Avrahami,* 2017 U.S. Tax Ct. LEXIS 40 at *2-*3. The entities that they controlled were treated as either S corporations or partnerships so that income and deductions flowed through them to the taxpayers. Based on advice received from a CPA and an attorney, in 2007, they set up a micro-captive,

known as Feedback, which was incorporated in St. Kitts. *Id.* at *6. After receiving approval to operate as a captive under the law of St. Kitts, it elected to be treated as a domestic corporation for federal tax purposes; it then elected to be taxed as a small insurance company under section 831(b) of the Code. *Id.* The Avrahamis worked with a lawyer named Clark who had experience in these matters.

Once Feedback was operational, it carried out two types of business: It issued policies to entities owned by the taxpayers, and it entered into an arrangement to reinsure terrorism insurance policies issued to other clients of Ms. Clark. *Id.* at *7. Although the taxpayers' businesses purchased insurance policies from Feedback, they made no changes to their existing commercial coverage. *Id.* at *9.

Initially, the reinsurance of terrorism risk exposure was handled through a cross-insurance arrangement. *Id.* at *28. Beginning in 2009, Feedback conducted its reinsurance operations with an insurance company known as Pan American Reinsurance, which was incorporated in St. Kitts and regulated by Nevis. Its shareholders included Ms. Clark's children, the wife of an individual who owned Feedback's management company, and a "courtesy director" who had no duties and no involvement with Pan American's daily operations. *Id.* at *29. Ms. Clark's captive clients would pay premiums to Pan American and receive a nearly equal amount in return. *Id.* at *30.

With these arrangements in place, the entities owned by the Avrahamis paid $730,000 in direct premiums, and one entity paid $360,000 for terrorism insurance in 2009, generating deductions of $1,090,000. For 2010, the premiums escalated to $1,170,000. *Id.* at *36. Because there were no claims, Feedback accumulated substantial surplus funds; these funds were disbursed through loans to an entity known as "Belly Button," which was affiliated with the Avrahamis. Technically, this entity was owned by the taxpayers' children, but they testified they knew nothing about it. *Id.* at *37. Feedback made a series of loans to Belly Button, some of which were not secured. *Id.* at *37-*39. One of these loans was used to fund a distribution from Belly Button to the Avrahamis, even though their children owned Belly Button.

After an unsuccessful audit for 2009 and 2010, the Avrahamis petition for Tax Court review, setting the stage for the trial. After making extensive factual findings, the court began its review by focusing on the standards that govern whether insurance exists for federal income tax purposes, which requires, among other things, shifting risk and distributing it. *Id.* at *44-*45 (citing *Helvering v. Le Gierse*, 312 U.S. 531, 539 (1941)).

In analyzing whether the contracts with Feedback involved insurance, the Tax Court started by focusing on risk distribution. Here, the court concluded that the requirement that risk be distributed were not met through its policies issued to affiliates for two reasons:

- First, Feedback only insured a limited number of entities, three in 2009, and four in 2010. at *58.
- Second, it had a limited number of types of risk exposure. at *59-*60.

Next, the court considered whether Feedback's relationship with Pan American sufficed to create risk distribution. While the taxpayers relied upon case law suggesting that a captive receiving 29% of its gross premium revenue from unrelated parties met the risk distribution requirement, in the Tax Court's view the Avrahamis first had to show that the reinsurance activities of Feedback involved insurance, starting with the question whether Pan American was itself a legitimate insurance company. *Id.* at *61. The Tax Court determined that Pan American was not a legitimate insurance company, given the circular flow of funds between it and the taxpayers, the unreasonable premiums it charged, and its apparent inability to pay claims; instead it was "just part of a tax-reduction scheme." *Id.* at *70. Since Pan American was not a bona fide insurance company, the taxpayers could not rely upon Feedback's reinsurance activities to demonstrate that the risk distribution requirement was met. *Id.* at *71.

While "[t]he absence of risk distribution" was "enough to sink Feedback," *id.* (citation omitted), the court went on to consider whether the arrangements established by the taxpayers looked like insurance in the commonly accepted sense of the term. Although Feedback was organized and regulated as an insurance company, the Tax Court expressed doubt about its operations, which "left something to be desired." *Id.* at *73. The court reasoned that the fact that its claims policy was described as "ad hoc" and that its funds were invested in illiquid, long-term loans to related parties were inconsistent with the operations of an insurance company. *Id.* It also did not help that there were no claims made under any policy until after the IRS began its audit. *Id.* at *73-*74. Once claims were made, they were paid in a haphazard fashion; late claims were accepted, and claims were paid without investigation. *Id.* at *74. Feedback's investment practices were also inconsistent with a finding that it operated like an insurance company: Not only had it tied up over 65% of its assets in long-term illiquid obligations, it had violated regulatory requirements that it obtain advance approval for loans to affiliates. *Id.* at *75.

The Tax Court also considered the terms of the policies and the reasonableness of the premiums charged by Feedback. The court observed that Feedback's policies were internally inconsistent, mixing together terms used in claims made policies and terms used in occurrence policies in the same contract. *Id.* at *77-*78. As for the premiums charged, the court noted that there was a dramatic escalation in cost experienced by the taxpayers' entities, and also cited evidence that policy terms were manipulated to keep the premiums within the maximum allowed to maintain small insurance company status and avoid paying income tax on premiums. *Id.* at *78-*82. Taken as a whole, the manner in which Feedback operated, its policy terms and the premiums that it charged led the court to determine that it was not offering insurance in the commonly understood sense of the term. *Id.* at *82.

Having concluded that Feedback did not distribute risk and did not sell insurance in the ordinary sense of the term, the Tax Court concluded that it was not offering insurance and elected not to evaluate any of the other relevant factors. For the Avrahamis, this meant that the deductions they had claimed through their various pass through entities were disallowed. *Id.* at *85.

The Tax Court made one other ruling directly bearing on micro-captive arrangements: The IRS had imposed an accuracy-related penalty on the taxpayers under section 6662(a) of the Code. The court sustained the Avrahamis' defense based on reasonable cause as to the premium deductions in a taxpayer-friendly determination. While the court discounted Clark's advice given her status as a promoter, it concluded that the advice of another lawyer who had provided the taxpayers with background on captives and had recommended that they work with Clark was sufficient to sustain a reasonable basis defense. *Id.* at *97-*99. The court acknowledged that this disposition was driven by the fact that the case was a matter of first impression.

On the merits, this appears to be a soundly-reasoned decision. Based upon the court's findings, it certainly appears that the case involves an effort to create a tax shelter, not an insurance arrangement. The court's risk distribution determination, however, casts a broader net by holding that a captive that only insures a limited number of related entities is not providing insurance. This suggests that a micro-captive designed to provide insurance to a single related entity will not generate a legitimate business deduction, even if it is operated in an appropriate fashion and is charging commercially reasonable premiums.[1] As a result, these cases just became much more difficult to defend.

It is also worth noting that the Tax Court reached this result without even reaching the question whether the arrangements lacked economic substance, which is usually a staple of tax shelter disputes.

***Footnotes:***

[1]This would clearly be the result under current law, as Congress amended section 831(b) in 2015 to impose diversification requirements. *See* I.R.C. § 831(b)(2)(B). Prior to the amendment, section 831(b) did not expressly require diversification.

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