October 19, 2017

Developments Regarding Micro-Captive Insurance Structures

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The Internal Revenue Code (IRC) provides favorable tax treatment to "small" casualty insurance companies the premium income of which does not exceed a specified dollar threshold each year. Such a small insurance company, when owned by the same persons as own the businesses that are insured by it, is commonly known as a "micro-captive." In 2016 the IRS issued a notice (IRS Notice 2016-66, 2016-47 IRB 745, modified by IRS Notice 2017-8, 2017- IRB 423) identifying micro-captive transactions as potentially abusive "transactions of interest" requiring special tax return reporting, and, earlier this year, the Tax Court issued a decision (Avrahami v. Commissioner, 149 T.C. No. 7) concluding that amounts paid to a micro-captive did not constitute "insurance premiums" for income tax purposes and could not be deducted. Notwithstanding the increasing scrutiny of such transactions, the relevant provision of the Internal Revenue Code (Section 831(b)) was amended in 2015 to increase the revenue ceiling below which insurers may qualify for treatment as "small" insurance companies. These developments are reviewed below.

Background

As discussed in *Avrahami*, captive insurance companies are used for many reasons, including the achievement of cost efficiencies that may permit a group of related properties or other businesses to be insured at a cost lower than the cost of insuring each property or business with a commercial insurer. It is well established, under cases and rulings cited in *Avrahami*, that such insurance premiums may be deducted as business expenses under IRC Section 162 where the arrangement (i) includes adequate (x) "risk shifting," to a person other than the person being insured, and (y) "risk distribution," a concept characteristic of insurance to the effect that where a large number of independent risks are pooled, the likelihood increases that the resulting loss across the pool will be close to the expected loss; (ii) involves "insurance risk" (as opposed to, say, investment risk); and (iii) otherwise meets commonly accepted concepts of insurance (a less clearly defined concept further developed in *Avrahami*).

Section 831(b) provides for an alternative tax computation based on taxable investment income that may be elected by a corporation conducing a non-life insurance business and collecting premiums that do not exceed a ceiling of $1,200,000 per year (prior to 2017).

Facts in *Avrahami*

Benyamin and Orna Avrahami and their children owned, through an S corporation (American Findings), three jewelry stores in the Phoenix metropolitan area, and, through other entities classified as S corporations and partnerships for tax purposes, leased commercial properties and land also located in Arizona. The aggregate insurance expense incurred with respect to these businesses prior to the formation of the captive was approximately $150,000 per year.

At the suggestion of the Avrahamis' long-time accountant, the Avrahamis consulted a lawyer in New York (Clark) with a focus on small captive insurance companies regarding the establishment of a captive insurance company. After further consultation by the Avrahamis with their Phoenix attorney regarding the use of such an arrangement, Clark and the Phoenix attorney were retained to implement a captive transaction, and a company (Feedback) was incorporated in St. Kitts. Feedback was authorized by St. Kitts to conduct captive insurance activities, and made elections to be treated as a domestic corporation under IRC Section 953(d) and as a small insurance company under Section 831(b). The sole shareholder of Feedback was Mrs. Avrahami.

Feedback provided insurance to the Avrahami entities for premiums exceeding $1,100,000 in 2009 and $1,300,000 in 2010 (the years at issue), while continuing the same insurance coverage with independent commercial carriers as was in place prior to the formation of Feedback. An actuary determined the pricing for the new insurance policies, but, at trial, the Avrahamis' actuary had difficulty explaining how the insurance premiums were determined.

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Some of the policies were for types of insurance that were commercially available but unusual for family retail and property leasing businesses, such as construction defects coverage, loss of business income as a result of reputational damage or new competition, or loss of income as a result of the departure of Mr. or Mrs. Avrahami from the jewelry store businesses. At least one policy, referred to as the tax indemnity policy and covering additional taxes, interest and penalties that a family entity might be obligated to pay as a result of an adverse resolution of a position taken on its tax return, was described as not generally available in the commercial insurance market.

In order to establish risk distribution, Feedback participated in a risk distribution program through another St. Kitts insurance company (Pan American) for terrorism coverage. In 2009, for example, American Findings purchased terrorism coverage from Pan American for an insurance premium of $360,000, and Pan American sold similar policies to other businesses that had affiliated captives and that participated in the program. Pan American ceded a percentage of its overall risk under the various terrorism policies in the program to each of the participating captives, including Feedback, for a premium that, with respect to each captive, approximated what its insured paid for terrorism coverage from the program. The terrorism policy was written as an "excess policy" and in such a way that covered claims were very unlikely to arise, and the premiums were greatly in excess of what was charged for somewhat similar insurance by commercial carriers.

No claims were made under any of the policies purchased through or otherwise involving Feedback until after commencement of the IRS audit of the Avrahamis. Feedback accordingly had a substantial surplus, more than $2 million of which was lent to an entity owned by the Avrahamis' children that in turn owned land in Arizona. The funds were lent at relatively low interest rates, for a multi-year period (ten years in at least one instance), and on an unsecured basis. (A smaller portion of the surplus ($200,000) was transferred directly by Feedback to Mrs. Avrahami.) Although St. Kitts insurance regulations required that loans to affiliated entities be approved in advance by the insurance regulators, no such approval was requested before the loans were made.

The IRS audited the returns of the Avrahamis, Feedback, and their entities for 2009 and 2010, questioned whether Feedback was a valid insurance company, and ultimately asserted that the premiums paid to Feedback were taxable to it on the basis that Feedback had not established entitlement to the special tax treatment provided by Section 831(b). The income passed through to the Avrahamis by their entities was increased by more than $1 million per year, reflecting the denial of the premiums as business expense deductions. The IRS also made adjustments by reason of the transfers from Feedback to the Avrahamis and the land-owning entity owned by their children, in part on the basis that certain loans should be recharacterized as distributions.

Analysis

The court concluded that the Feedback policies failed the risk distribution requirement for insurance. Apart from the terrorism insurance coverage, the affiliated entities and their activities were too closely aligned and insufficiently numerous to provide adequate risk distribution.

With respect to the terrorism coverage provided by Pan American, the court concluded that Pan American was not a bona fide insurance company, citing factors including atypical language in its policies making it very unlikely that a claim would ever be made, excessive premiums, thin capitalization of Pan American itself, and doubts as to its ability to enforce the cession agreements against the numerous captive insurers. The agreements of Feedback with Pan American were therefore insufficient to provide the necessary risk distribution for Feedback's arrangements to constitute insurance.

The court further found that Feedback was not operated in a manner consistent with its being an insurance company, taking into account its investment choices (lending money on a long-term, illiquid, and unsecured basis), that it processed claims (made after the IRS audit commenced) in an ad hoc manner not fully consistent with policy terms and normal insurance practices, issued policies with unclear and contradictory terms, and charged excessive premiums.

The court therefore concluded that Feedback's elections to be taxed as a domestic corporation, and as a small insurance company under Section 831(b), were ineffective because Feedback was not an insurance company.

The Avrahamis' income was increased by reason of the denial of insurance premium deductions to their entities, and by dividend income to the extent amounts transferred by Feedback to Mrs. Avrahami were conceded by the Avrahamis or otherwise treated as distributions with respect to stock taxable as a dividend. The dividend did not qualify for treatment under IRC Section 1(h) as qualified dividend income, because Feedback was ultimately determined to be a foreign corporation for federal tax purposes and was not eligible for benefits under an income tax treaty with the United States.

The substantial understatement penalty asserted against the Avrahamis under IRC Section 6662 was not sustained, however, to the extent the penalty was premised on the disallowance of the deductions for insurance premiums, because of the "reasonable cause" exception of IRC Section 6664. The court found that the Avrahamis acted reasonably by relying on advice from their Phoenix attorney who had a prior relationship with the Avrahamis, did not provide unsolicited advice, billed for the most part on an hourly basis (rather than on the basis of the fixed transaction fee and fixed annual fees as charged by Clark), and "gave his blessing" to the arrangement (per testimony from Mr. Avrahami that the court found to be credible).

The court also concluded that this reliance was in good faith, taking into account that this was a case of first impression where there was, in the court's view, no clear authority to guide taxpayers on micro-captives and on the interplay of IRC Sections 162 (regarding the deductibility of business expenses), 831(b), and 953(d).

Other Developments Relating to Micro-Captives

IRS Notice 2016-66 announced that a micro-captive transaction as described therein (similar to that which was later addressed in *Avrahami*) was a "transaction of interest," such that persons entering into such transactions, including "material advisors" with respect to such transactions, are subject to disclosure and list maintenance requirements referenced in the notice.

Section 831(b) was amended by P.L. 114-113 (2015), effective for taxable years beginning after 2016, to increase the limit on net written annual premiums for Section 831(b) small insurance companies from $1,200,000 to $2,200,000, and to add diversification requirements under which either (i) not more than 20% of the insurer's premiums for a taxable year may be attributable to any one policyholder (with policyholders that are related being treated as one policyholder), or (ii) the ownership of the insurer and of the businesses with respect to which the net premiums are paid must meet a standard that precludes any person who is a spouse or lineal descendant of a person owning an interest in the insured businesses from owning a greater percentage interest in the insurer that in the insured businesses.

Observations

Avrahami was at least arguably an extreme case in several respects, but seems likely to encourage the IRS to pursue tax adjustments with respect to transaction structures involving micro-captives.