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KPMG report: No deduction for amounts paid captive insurance company (U.S. Tax Court's opinion)

The U.S. Tax Court on August 21, 2017, issued an opinion finding that amounts paid by the taxpayers to a captive insurance company taxed under section 831(b) were not insurance premiums for federal income tax purposes and were not deductible.

The case is: *Avrahami v. Commissioner*, 149 T.C. No. 7 (August 21, 2017). Read the 105-page **opinion** [PDF 370 KB]

The following discussion provides initial impressions and observations about the court's opinion.

Background

The taxpayers (husband and wife) owned three shopping centers and "three thriving jewelry stores" in Arizona. In 2006, the taxpayers spent a little more than $150,000 insuring them. In 2009, this insurance bill was more than $1.1 million and then in 2010, more than $1.3 million. The court's opinion states that the taxpayers were paying the overwhelming share of these bills to a new insurance company that was wholly owned by the wife.

The taxpayers organized a captive insurance company ("Feedback") in St. Kitts in 2007. Feedback elected to be treated as a domestic corporation under section 953(d) and to be taxed as a small insurance company under section 831(b). During 2009 and 2010, Feedback issued policies to taxpayer-affiliated entities for administrative actions, business risk indemnity, business income, employee fidelity, litigation expense, loss of key employee, and tax indemnity. The Tax Court extensively discussed the pricing actuary's methodology for pricing these policies.

Feedback also participated in a risk distribution program through Pan American Reinsurance Company, Ltd. ("Pan American"). Pan American was intended to establish risk distribution by providing terrorism risk insurance. Feedback purchased

terrorism risk insurance from Pan American and reinsured terrorism risk insurance from Pan American.

No claims were made on any of the insurance policies until the IRS began audits of the taxpayers' returns and of the returns of their various entities. The captive insurance company had accumulated a surplus of more than $3.8 million by the end of 2010—$1.7 million of which ended up back in the taxpayers' bank account as loans and loan repayments.

The taxpayers claimed deductions under section 162 on their 2009 and 2010 tax returns for amounts paid by their passthrough entities to the captive insurance company and to an off-shore company that reinsured a portion of its risk with the captive insurance company.

IRS findings

The IRS denied the deductions and determined that the insurance company's elections under section 831(b) to be treated as a small insurance company and under section 953(d) to be taxed as a domestic corporation were invalid because the amounts paid did not qualify as insurance premiums for federal income tax purposes.

The IRS also determined that amounts transferred out of the insurance company were distributions to the taxpayers—not loans—and that the taxpayers were liable for accuracy-related penalties under section 6662(a).

Tax Court's opinion

Based on Tax Court precedent, the court applied a four-pronged test. Specifically, to be considered insurance, the arrangement must:

- Involve risk shifting
- Involve risk distribution
- Involve insurance risk
- Meet commonly accepted notions of insurance

Risk distribution

The court noted that, absent the Pan American arrangement, Feedback was only insuring three or four affiliated entities. Neither the IRS nor the taxpayers argued that this number of entities was sufficient. Instead, the taxpayers argued that the arrangement with Pan American provided sufficient risk distribution.

Before it could find that Feedback had sufficient risk distribution through its arrangement with Pan American, the court examined whether Pan American was a bona fide insurance company. Interestingly, rather than analyze the Pan American

arrangement under the four prongs for qualifying as insurance (as listed above), the court listed the following nine factors:

- Whether the company was created for legitimate nontax reasons
- Whether there was a circular flow of funds
- Whether the company faced actual and insurable risks
- Whether the policies were arm's length contracts
- Whether the entity charged actuarially determined premiums
- Whether comparable coverage was more expensive or even available
- Whether the entity was subject to regulatory control and met minimum statutory requirements
- Whether it was adequately capitalized
- Whether it paid claims from a separately maintained account

The Tax Court found that Pan American was not an insurance company. Specifically, the court found that several of the factors (described above) weighed against characterizing Pan American as an insurance company. For example, the court found that there was a circular flow of funds from an entity owned by the taxpayers to an entity owned by the wife. The court also found that the premiums charged by Pan American were "grossly excessive" and questioned whether contracts and the underlying pooling arrangement reflected an arm's length business arrangement.

Interestingly, citing recent cases, the court noted that risk distribution was not satisfied by examining the number of brother-sister entities. Rather, the court quoted from *Rent-a-Center, Inc. v. Commissioner,* 142 T.C. 1, 16 (2014) approvingly, by stating that "…risk distribution is satisfied with a finding of a sufficient number of statistically independent risks." Based on these and other factors, the Tax Court found that it was more likely than not that Pan American was not a bona fide insurance company even though it was regulated and adequately capitalized under the local jurisdiction.

Because Pan American was not a bona fide insurance company, Feedback did not have sufficient risk distribution.

Insurance in the commonly accepted sense

To determine whether Feedback provided insurance in the commonly accepted sense, the court examined the organization, operation, and regulation of Feedback. Both the taxpayers and the IRS agreed that Feedback was incorporated and regulated as a captive insurance company in St. Kitts. However, the court deferred any analysis of the IRS's argument that Feedback was subject to, and in violation of, Arizona insurance regulations.

The court analyzed whether Feedback operated as an insurance company, and found that "Feedback's operations left something to be desired." The court noted that Feedback only dealt with claims on an "ad hoc" basis and that it invested in illiquid, long-term, and partially unsecured loans to related parties and failed to obtain regulatory approval. The court further found that, prior to the start of the IRS audit, the insured entities made no claims against the policies, and that once made, most of the claims were approved despite being filed late or providing evidence supporting the claim.

The court also reviewed whether Feedback was adequately capitalized and whether the policies were valid and binding. The court found that the policies were "less than a model of clarity" and that the "premiums were utterly unreasonable." Even though Feedback paid its claims, the court found that the arrangement was not "insurance in the commonly accepted sense."

Conclusion

Because the Tax Court found for the IRS with respect to the risk distribution and insurance in the commonly accepted sense issues, the court did not address the IRS's arguments under economic substance, substance-over-form, and step-transaction doctrines.

The Tax Court's opinion, generally upholding the deficiency determination, concludes that:

- The amounts paid to the captive insurance company and the off-shore company were not insurance premiums for federal income tax purposes and were not deductible under section 162.
- The elections under sections 831(b) and 953(d) were invalid for 2009 and 2010.
- The amount transferred directly from the captive insurance company to the wife was an ordinary dividend.
- The amount transferred indirectly from the captive insurance company to the taxpayers was not taxable to the extent it was a loan repayment, but the excess was either taxable interest or an ordinary dividend.
- The taxpayers were not liable for accuracy-related penalties under section 6662(a) except in relation to the amounts determined to be ordinary dividends or taxable interest.

KPMG observation

The Tax Court decision in *Avrahami v. Commissioner* is the first case analyzing section 831(b) captives since the IRS highlighted its concern with these arrangements—read the discussion about Notice 2016-66 in ***TaxNewsFlash-United States***.

The Tax Court applied the four-prong test developed in *Helvering v. LeGierse,* 312 U.S. 531 (1941), and its progeny, to conclude that the taxpayers' arrangement failed to satisfy the risk distribution and insurance in the commonly accepted sense criteria.

The court's detailed analysis and factual findings can serve as a template for other captives, including micro-captives, to review their arrangements. This opinion is a strong reminder that the determination of which captive entities qualify as insurance for federal tax purposes relies heavily on facts and circumstances. There are no bright line tests.

Of note, the Tax Court affirmatively cited three recent decisions—the *Rent-a-Center* case and *Securitas Holdings, Inc. v. Commissioner,* T.C. Memo. 2014-225, and *R.V.I. Guaranty Co., Ltd. v. Commissioner,* 145 T.C. 209 (2015). The opinion states that in determining the existence of risk distribution, it is not sufficient to test only the number of insured brother-sister affiliates. The court stated that it is "even more important to figure out the number of independent *risk exposures*." [Emphasis in original.] This position relies heavily on the *R.V.I.*, *Rent-a-Center,* and *Securitas* cases and increases the importance of those opinions.

While the Tax Court did not reach a conclusion on whether the taxpayers' arrangement had economic substance, it is noted that the IRS argued economic substance, substance-over-form, and step-transaction. Given the high level of IRS interest and the stringent penalties that would come into effect if a transaction lacks economic substance, prudent taxpayers would consider reviewing their captive arrangements to determine that their facts and circumstances support the federal tax treatment.

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