Case Alert

Captive Owners Face the Music in Long-Awaited Tax Court Decision

According to Thomas Carlyle, “Everywhere in life, the true question is not what we gain, but what we do.” According to the United States Tax Court’s recent decision on small captive insurance companies, *Benyamin Avrahami and Orna Avrahami v. Commissioner of Internal Revenue*, 2017 WL 3610601, the true question is what we do to keep what we gain. One thing we can’t do is use the captive insurance structure to hide money from the IRS.

Section 831(b) of the Tax Code establishes tax benefits for captives whose held premium remains under $2.2 million.[1] Captives that exploit these benefits have long been objects of suspicion for the Tax Commissioner.[2] In *Avrahami*, the Commissioner found an example ripe for the making: owners of a jewelry business who paid over $1.5 million in insurance premiums over four years to their own captive, which only began paying claims after the IRS conjured the specter of an audit. *Avrahami*, 2017 WL 3610601, at *16. After the case was litigated, the Tax Court agreed with the Commissioner that the Avrahamis’ captive was not insurance and that their premium payments to the captive were not deductible as ordinary and necessary business expenses.

A captive owner cannot enjoy tax benefits unless the captive actually functions as an insurance company. Specifically, a captive arrangement must involve the existence of “insurance risk” and be “insurance” in its commonly accepted sense; it must also shift and distribute that risk. *See R.V.I. Guar. Co. Ltd. & Subsidiaries v. Commissioner,* 145 T.C. 209 (2015); *Rent-A-Center v. Commissioner*, 142 T.C. 1, 13 (2014); *Harper Group & Includable Subsidiaries v. Commissioner*, 96 T.C. 45 (1991).

The *Avrahami* Court focused on whether the captive distributed risk and sold “insurance” in its commonly accepted sense. The Court held that the Avrahamis’ captive did not sufficiently distribute its risk because the reinsurance program that it relied on for risk distribution was itself not a bona fide insurance company. *Avrahami*, 2017 WL 3610601, at *25.

But the more interesting aspect of the decision was the Court’s finding that the captive was not “insurance” in its commonly accepted sense. In coming to this conclusion, the Court looked beyond regulatory benchmarks and considered how the captive operated as an insurance company. *Id*. at *26. The Court noted, for example, that, in 2009 and 2010, the Avrahamis paid more than $1 million in premium each year, while otherwise maintaining commercial coverage through main-stream insurance carriers for less than $90,000 a year. *Id*. at *27. The captive also made a series of long-term, partially unsecured loans to related Avrahami entities, which accounted for 65% of the captive’s assets by the end of 2010. The Court was also concerned with the Avrahamis’ odd claims activity. *Id*. at 26. Their affiliated corporations made no claims against their captive from the time of its inception in 2007 until March of 2013, when it became clear that the IRS was suspicious about the legitimacy of the captive.

This case is likely to be reviewed and studied in more detail in the coming months and years. But the take-away for now is that small captives must do more than meet regulatory benchmarks to be considered insurance companies for tax purposes. They must operate as insurance companies; which is to say, they must actually accept and distribute legitimate risk.

For more information about this case contact Brian J. Clifford at bjc@sdvlaw.com or 203.287.2117.

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1. A non-life insurance company with net written premium of less than $1.2 million could elect to be taxed only on its taxable investment income rather than being taxed on its income the way corporations are. At the time of the events in this case, the premium ceiling was $1.2 million.
2. https://www.irs.gov/newsroom/irs-warns-of-abusive-tax-shelters-on-2017-dirty-dozen-list-of-tax-scams