**AVRAHAMI v. COMMISSIONER**

# FAILED CAPTIVE SHOWCASES NEED FOR EXPERT PLANNING

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CAPTIVE INSURANCE PLANNING FOR THE MIDDLE MARKET

# *Avrahami V. Commissioner: Failed Captive Showcases Need for Expert Planning*

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The U.S. Tax Court issued its long-anticipated decision in *Avrahami v. Commissioner*[1] on August 21, 2017. The Tax Court issued a fact-specific ruling that denied federal income tax deductions for premiums paid by the Avrahamis' insured businesses to Feedback Insurance, Ltd. (Feedback), the Avrahamis' captive insurance company. As presented in the Court's opinion, the facts left little room for the Tax Court to decide otherwise.[2]

## FACTS OF THE CASE

By way of background, Mr. and Mrs. Avrahami, through American Findings Corporation (dba London Gold), owned and operated three retail jewelry stores that employed approximately 35 people in the Phoenix-metropolitan area. The Avrahamis sought to provide these jewelry stores with supplemental insurance through Feedback, which was domiciled in St. Kitts, an island nation in the West Indies that is part of the independent country known as the Federation of St. Kitts and Nevis. The insureds were American Findings and three real estate businesses also owned by the Avrahamis. One real estate company owned a commercial building and leased space to the jewelry stores and other tenants. The second real estate company held title to commercial real estate and operated a retail shopping center in Phoenix. The third insured real estate business owned a commercial strip mall in Tempe, Arizona and leased space to several tenants, including a charter school.

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1 149 T.C. No. 7 (Aug. 21, 2017).

2 This article is based on the Tax Court's findings and conclusions, which are not yet final and are subject to appeal. Although the Tax Court has issued its opinion, as of this writing, no decision has yet been entered. The most recent docket sheet for this case can be found at the following link to the Tax Court's website: https://www.ustaxcourt.gov/UstcDockInq/DocketDisplay.aspx?DocketNo=16016792.

Feedback participated in Pan American, a reinsurance pool also based in St. Kitts, which issued only terrorism insurance to Feedback's insured businesses and also issued terrorism insurance to more than 100 other unrelated insureds. Pan American ceded all its terrorism risks to Feedback and the other participating captives through a Terrorism Risk Quota Share Reinsurance Agreement.

The tax years at issue were 2009 and 2010. For the 2009 tax year, Feedback received $360,000 in premiums from Pan American and $730,000 in premiums from entities owned by the Avrahamis. Likewise, in 2010, Feedback received $360,000 in premiums from Pan American and $810,000 in premiums from entities owned by the Avrahamis. Pan American received $360,000 in premiums each year from the Avrahami insureds for a terrorism policy. Feedback' s income tax returns for both 2009 and 2010 included an election for Feedback to be treated and taxed as an insurance company under §831(b).[3] In addition, Feedback filed an election in 2008 under §953(d) to be treated as a domestic corporation for federal income tax purposes, which was approved by the IRS. If Feedback's §831(b) election were valid, Feedback would not have been taxed on the premiums received in the 2009 or 2010 tax years, as provided under §831(b), as long as the total premiums received by Feedback in any calendar year were less than $1.2 million. The Tax Court held that, because Feedback failed to qualify as an "insurance company" for federal income tax purposes, its §831(b) election was invalid for both tax years at issue and that its §953(d) election was invalid as well.

The Tax Court held that the insurance arrangement presented did not have sufficient "risk distribution" and was not "insurance in the commonly accepted sense." Thus, the Tax Court held that Feedback was not an insurance company for federal income tax purposes. The Tax Court also held that the payment of premiums to Feedback by the insureds did not qualify as ordinary and necessary business expenses under §162(a), which meant that such payments were not deductible by the insureds.[4]

Well-recognized case law has established that to be treated as an insurance company, an entity must satisfy the following four requirements: (i) risk shifting, (ii) risk distribution, (iii) insurance risk, and (iv) common notions of insurance.[5]

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[3] All section references are to the Internal Revenue Code of 1986 ("Code"), as amended, and the Treasury Regulations promulgated thereunder, unless otherwise specified.

[4] In addition, although the premiums received by Feedback were held to be taxable as a result of both its §831(b) election and §953(d) election being held invalid, the parties stipulated that such premiums were not taxable to Feedback.

[5] *Helvering v. Le Gierse*, 312 U.S. 531 (1941); *AMERCO, Inc. v. Commissioner*, 96 T.C. 18 (1991), *aff'd*, 979 F.2d 162 (9th Cir. 1992); *Sears, Roebuck & Co. v. Commissioner*, 96 T.C. 61 (1991), *aff'd in part and rev'd in part*, 972 F.2d 858 (7th Cir. 1992); *Rent-A-Center, Inc. v. Commissioner*, 142 T.C. 1 (2014); *Securitas Holdings, Inc. v. Commissioner*, T.C. Memo. 2014-1630.

In *Avrahami*, the Tax Court focused on risk distribution and common notions of insurance to negate the existence of an insurance relationship between Feedback and the Avrahamis' insured businesses.

The fact pattern that *Avrahami* presented to the Court foreshadowed the adverse result.

**Unfavorable Facts Emphasized by the Court**

- The four affiliated companies insured by Feedback did not have a sufficient number of independent risks among them.
- The taxpayer's actuary could not explain to the satisfaction of the court the basis of premium calculations for the captive or the pool.
- Only one risk – terrorism – insured by Feedback was pooled or distributed.
- None of the other policies issued by Feedback were pooled or distributed.
- The terrorism policy issued by the pool was "grossly overpriced" and was redundant with commercial coverages.
- The §831(b) election combined with the annual receipt of just under $1.2 million in premiums, the exact statutory limit, was highly suspicious.
- Approximately 65% of Feedback's assets were loaned to an entity owned by the Avrahamis' children, who testified that they had no knowledge about the entity.
- Interest was not paid currently on loans by the captive to the affiliated entities, but it was accrued and added to principal over a number of years.
- Loans by Feedback to shell entities were largely unsecured, and loaned funds were immediately transferred out of such entities to the Avrahamis' personal account.
- The Pan American pool was thinly capitalized with limited liquidity such that the pool did not have the financial wherewithal to pay losses for a covered terrorism event.
- No claims were filed by the insured entities against Feedback until after the IRS audit commenced.
- The captive terrorism premium of $360,000, the sole pooled policy, appeared to be overpriced and priced with the purpose of achieving risk distribution.

**ANALYSIS**

**Problems with Risk Distribution, Pool's Attempt at Risk Diversification**

The IRS argued that risk distribution, which is an essential component of an insurance arrangement, was lacking. The Avrahamis argued that Feedback, their captive insurance company, distributed risk by participating in a "risk pool," which was a reinsurance arrangement that only included terrorism risks. The other risks insured by Feedback, consisting of approximately 70% of the total dollar premiums, were not pooled or distributed and were held only by Feedback. These other risks borne by Feedback consisted of the following:

- Business income
- Employee fidelity
- Loss of key employee
- Tax indemnity
- Administrative actions
- Business risk indemnity

The Avrahamis' argued that, in previous cases, the Tax Court had found risk distribution to exist by mechanically looking at the percentage of the captive's gross premiums received from unrelated insureds relative to total premiums. The Avrahamis cited *Harper Group. v. Commissioner,*[6] which was affirmed by the Ninth Circuit, in which the Tax Court found that a captive had achieved sufficient risk distribution where at least 29% of the captive's gross premium revenue came from unrelated parties.

Disagreeing with the Avrahamis' narrow interpretation of *Harper*, the Tax Court explained that the issue was not as simplistic as merely looking at the arithmetic percentage of the captive's gross premiums that were derived from unrelated parties. Instead, the Tax Court examined the details underlying the pooling arrangement to determine whether it was a valid insurance arrangement. The Tax Court viewed it as necessary to determine whether Pan American was a bone fide insurance company before it could make a conclusion on whether Feedback distributed risk through the Pan American pooling program. Once the Tax Court determined that Pan American was not a bona fide insurance company, it held that Feedback did not meet the 29% outside business test for sufficient risk distribution.[7]

The Tax Court focused on several factors, discussed below, in finding that the Pan American pool was not a bona fide insurance company.

**Circular Flow of Funds**

The Tax Court concluded that the pool was structured so that Feedback would receive a reinsurance premium from Pan American equal to the amount that the Avrahami insureds paid to Pan American for terrorism coverage. The Tax Court viewed this fact as suspicious because the result was the transfer of money from one entity owned 100% by the Avrahamis to another

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[6] 96 T.C. 45 (1991), *aff'd*, 979 F.2d. 1341 (9th Cir. 1992).

[7] It is unclear why the Tax Court needed to decide if Pan American was a bona fide insurance company. For example, it would have been sufficient for the Tax Court to find that the terrorism policy was not insurance or to conclude that sufficient risk distribution did not exist due to only one type of policy being pooled.

entity also owned entirely by them. The Tax Court emphasized the fact that amounts received by Pan American as premiums "were then cycled back whence they came," with 50% being returned to the participating captives after 90 days, another 47.5% being returned after 180 days, and the balance of 2.5% received by Pan American being held back as a "loss reserve." This remaining balance was returned to each participating captive when the policies expired on December 15th of the relevant policy year. Thus, 97.5% of the premiums received by Pan American were distributed to the captive reinsurers halfway through the policy period, with the Tax Court concluding that Pan American would likely not have sufficient funds to pay a covered claim during the last six months of such year.

The Tax Court also noted that the policies written by Pan American were unclear as to whether they were occurrence policies or claims-made policies, with occurrence policies having liability well beyond the policy period. Because all funds had been distributed to the participating captives by December 15th of the relevant policy year, there was no time period during which claims could be made or disputes could be resolved after the end of such year. In the event of a terrorism claim, Pan American would have to go to its reinsurers, which were captive insurance companies set up by the Avrahamis' tax attorney (Celia Clark), to obtain the cash to pay claims.

The Tax Court's analysis did not take into account that reinsurance pools, by their nature, involve to some degree a circular flow of funds. By definition, a pool is a reciprocal arrangement among participants who share their risks in exchange for a premium. Cash flows are circular in nature because individual risks are first transferred to the pool, which blends the risks and then transfers the blended risks to the pool participants. Pools are common in the insurance industry as a means of diversifying and distributing risks.

The IRS has explicitly approved the use of pooling or quota share reinsurance arrangements involving circular cash flows as a means of spreading, distributing, or blending risk in circumstances in which an insured's premium approximated the reinsurance premium ceded to an associated captive.[8] Moreover, the Treasury Department has commented favorably on reinsurance arrangements that involve this type of risk pooling.[9]

At the same time, the Tax Court's analysis emphasized that the pool was inadequately capitalized (given its risk bearing position) and retained very little assets to satisfy its obligations. As the Tax Court noted, the reality of the Pan American pooling arrangement was that, if a covered claim came in, the pool would have to go to each of the participating captive reinsurers to get the necessary cash to pay the covered claim. If a given reinsurer wouldn't or couldn't pay, then Pan

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[8] PLR 201219011, PLR 201224018.

[9] Fed. Ins. Office, U.S. Dep't of Treas., *The Breadth and Scope of the Global Reinsurance Market and the Critical Role Such Market Plays in Supporting Insurance in the United States* (Dec. 2014).

American would have to foot the bill itself. The Court stated that "Pan American would be hard pressed to enforce the cession agreements against the scores of captive insurers that it might have to go after."

The fact that Pan American would probably be unable to pay any covered claims appears to be the factor that garnered the most emphasis by the Tax Court. While the "cession agreements" may have technically transferred the pool's obligations to the reinsurers, the inadequate capitalization of Pan American combined with the reality that Pan American would have difficulty enforcing the cession agreements against the reinsurers caused the Tax Court to find that Feedback's participation in the pool did not achieve risk distribution. The following paragraphs from the IRS's answering brief, illustrate why Pan American lacked the ability to sustain the potential losses that were underwritten by the pool.

> Although Pan American had Clark's clients as reinsurers, Petitioners offered no evidence that Pan American's reinsurance participants (Clark's clients) had the capability to sustain the potential losses under the Pan American policies. Even if they did, Pan American did not have sufficient capital, or incentive, to force its reinsurers to pay up, through litigation, and because of the unusual manner in which it operated, Clark's clients did not even understand the risk that they purportedly undertook in the Pan American arrangement, which invites litigation.
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> Pan American did not have sufficient capital to sustain litigation for even a year, let alone more than ten years, and nobody stepping into Pan American's shoes could recover from its reinsuring participants without sufficient capital.[10]

The following diagram, from the Avrahamis' opening brief,[11] depicts the relationship among Pan American, Feedback, and the insured operating businesses.

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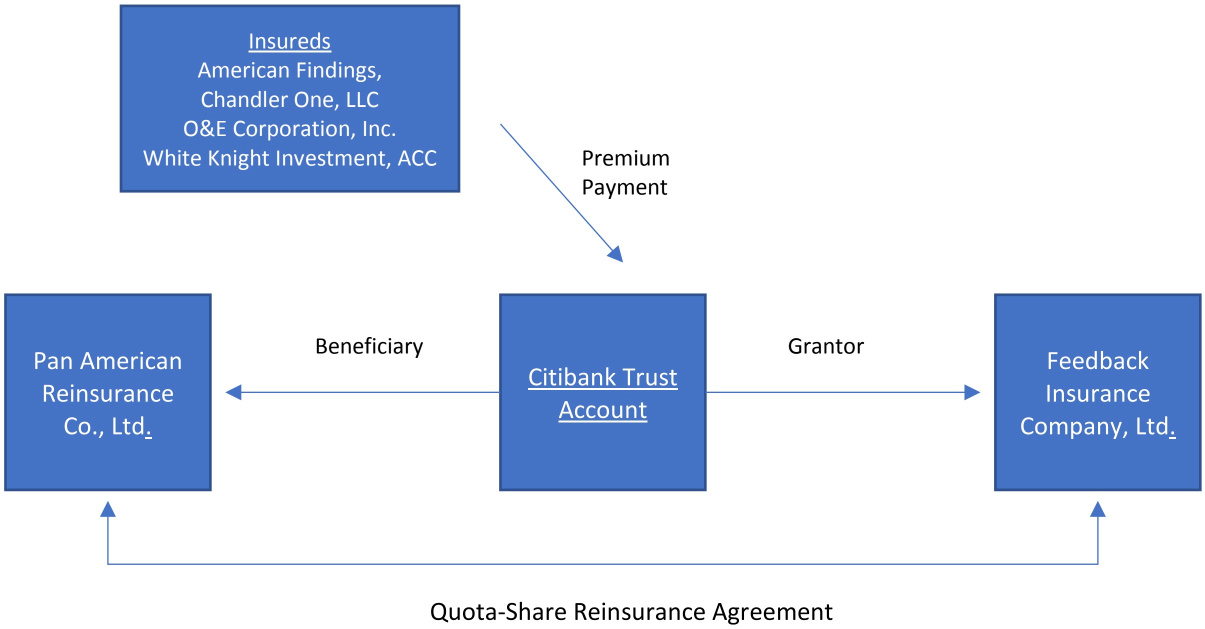
[10] Answering Brief of Respondent at 325-326, *Avrahami v. Commissioner*, 149 T.C. No. 7 (Aug. 21, 2017), No. 17594-13 (T.C. Oct. 2, 2015).

[11] Opening Brief of Petitioner at 31, *Avrahami v. Commissioner*, 149 T.C. No. 7 (Aug. 21, 2017),No. 17594-13 (T.C. Jul 31, 2015).




- Premiums paid by the insureds were deposited into a trust account for the benefit of the Pan American pool.
- Reinsurers, including Feedback, were grantors under the Trust Agreement.
- Pan American was responsible for paying reinsurance premiums to the reinsurance companies, subject to claims owed to the insured entities.

Under this reinsurance arrangement, the trust account was established under a trust agreement, and premiums were paid into this account by the persons buying insurance from Pan American. The premiums were held by the trustee, or under the trustee's supervision, as security for claims. Under the trust agreement, Clark was the trustee, Pan American was the beneficiary, and the reinsurance companies were the grantors. Pan American was responsible for paying the reinsurance premiums to the reinsurance companies, subject to claims. Although not commented on by the Tax Court, this structure is not typical in the insurance industry.

**Unreasonable Premiums**

Numerous facts strongly suggested that the premium charged by Pan American to Feedback for the terrorism reinsurance was not reasonable, including the testimony of the taxpayer himself, the emails from the taxpayer's lawyer, and the testimony of the taxpayer's expert.

The Tax Court noted that, first, the Avrahamis' actuary, Allen Rosenbach, a sole practitioner holding the designation of FSAC (Fellow of the Casualty Actuarial Society), made no comparison in his "market study" between the rates charged by the pool for terrorism reinsurance and the rates charged by commercial insurers that actually provided similar base coverage.

Second, the Tax Court noted that the actuary recommended a "one-size-fits-all" premium rate to be charged by the pool to all the captive clients that were referred to the actuary by Clark, regardless of each client's geographic location or other factors. Thus, a client located in midtown Manhattan or on Pennsylvania Avenue near the White House in a prime office building occupying significant space, would be charged the same absolute dollar amount for coverage as the Avrahamis' suburban Phoenix retail stores.

There was no explanation for Pan American's one-size-fits-all rate where the Pan American policies for many captives were at least partially duplicative of other commercial terrorism policies and were written on an excess-coverage basis, in which the risk assumed by the pool was only the portion of a loss not covered by another policy. Pan American charged the same rate to all its participants, regardless of their geographic location and size of their operations. The traditional role of an underwriter, which typically involves examining the generalized pricing provided by an actuary and then making necessary adjustments to the coverages, was absent. In other words, no "underwriter's judgment" was being applied to the raw numbers that were provided by the actuary to reflect the different risk factors that applied to each of the pool's participating captives.

The actuary attempted to defend the pricing of the terrorism policies issued by Pan American by emphasizing the fact that those policies covered damage caused by dispersion of biological or chemical agents, which is excluded under most policies backed by the Terrorism Risk Insurance Act (TRIA), such as the Avrahamis' commercial policies. The IRS's answering brief asserted that Rosenbach's reports "did not include rates charged by specific carriers" despite his knowledge that certain carriers were providing nuclear, chemical, biological, and radiological (NCBR) coverage on a stand-alone basis. The Avrahamis countered that Rosenbach testified that "80 to 90 percent of the rate" charged by Pan American was related to chemical and biological coverage. The Tax Court was not convinced that the premiums charged by Pan American were reasonable, perhaps best explained by other adverse factors cited by the Court (e.g., Pan American's dissipation of its premium, contradictory policy language as to whether the policy was an occurrence or a claims-made policy, the duplication of coverage with commercial insurance, and the huge premium being charged for the captive coverages, which were in part back-stopping commercial policies).

This combination of facts led the Tax Court to find that the premiums charged by the Pan American pool were "grossly excessive."

**Lack of Arm's-Length Contracts and No Material Risk Borne by the Pool Participants**

An additional problem with the Pan American pool was the apparent lack of an arm's-length relationship between the pool and each participating captive. Under the terms of the pooled policy, the possibility of a covered loss being triggered under what the Tax Court described as the "carefully designed terrorism risk pool" was so low that the Avrahamis' actuary admitted that "he did not know of any event in history" that would have triggered coverage. The Pan American pool structure made it very unlikely that any claims would ever be made against the pool. The terrorism coverage underwritten by the pool was so narrowly drafted that coverage was triggered "only when a terrorism event was declared as such by a Cabinet-level government official with over $100 million in damage, but at the same time did not cover attacks in cities, however defined, with a population of over 1.5 million people." Although the term "city" was not defined in the policies issued by Pan American, according to the IRS's answering brief, nearly half of the insureds that were issued policies by Pan American were based in locations that could only be construed as "cities" by any definition – including Los Angeles, New York, Houston, Cleveland, Miami, Phoenix, and Las Vegas. Thus, the coverage exclusion for cities with a population of over 1.5 million people applied to a significant portion of the insured parties to which Pan American issued terrorism coverage.

In addition, the pool was very thinly capitalized. Although Pan American was capitalized with the minimum required capital of $75,000 under the laws of Nevis, because the pool's policies covered large-scale terrorism attacks that could potentially cause losses in excess of $100 million, it was obvious according to the Tax Court that Pan American did not have sufficient capital to be able to pursue and recover from its captive reinsurers in the unlikely event of a covered loss.

It was also clear that the participants in the Pan American pool did not understand the pooling arrangement or how much was "at risk" due to their participation in the pool. Mr. Avrahami testified at his deposition that the Pan American arrangement only put the amount of premiums paid to Feedback at risk. That is, Mr. Avrahami testified that his captive's exposure on a terrorism policy having a $360,000 premium was $360,000. This fact on its own appears to negate the presence of insurance. When asked whether he could lose money from the Pan American arrangement, Mr. Avrahami replied, "that would be weird." Mr. Avrahami further testified that he would "freak out" if he lost money.

Given the negligible risk borne by the pool participants combined with the fact that the pool participants themselves, including Mr. Avrahami, did not believe that they could lose money as a result of participating in the Pan American pooling arrangement, it was not difficult for the Tax Court to conclude that no material risk was being borne by the pool participants and that no arm's-length relationship existed between the pool and each participating captive.

**Failure of the Pool to Operate as a Bona Fide Insurance Company**

The Tax Court determined that Pan American was not an insurance company and concluded that its policies were not insurance. Based on this conclusion, the Tax Court held that Feedback's reinsurance of those same policies did not distribute risk.

It was not necessary for the Tax Court to find that Pan American was not a bona fide insurance company to reach the conclusion that Feedback's participation in the Pan American pooling arrangement failed to achieve sufficient risk distribution. To be sure, an effective pooling arrangement can be structured as a mere cross contractual agreement, a trust, or as a pure pass-through. What matters is whether the policies issued by Pan American were policies of insurance. While the Tax Court's focus on whether Pan American was an insurance company did not appear to be necessary, the Tax Court ruled that the inadequacies of the Pan American pooling arrangement caused Feedback to fail to meet the risk distribution requirement.

The Tax Court also placed emphasis on the pool's atypical fee structure, whereby the pool did not charge a typical "ceding commission" to the participating captive reinsurers and instead only charged a small "insurance pool administration fee." It is of little consequence whether a ceding commission is charged by the pool because the net financial impact to each participating captive is ultimately zero if the amount of the commission charged is ultimately passed through to each participating captive reinsurer or borne by an insured on a pro rata basis. To be sure, the pool could have been structured on a mere cross contractual or escrow account basis without the benefit of Pan American as a legal entity. The question of what is an appropriate charge for any ceding, beyond covering administrative fees, should be largely dependent on the residual risk, if any, borne by the pool. The parties' briefs and the opinion were devoid of this discussion.

At the end of the day, the obviously excessive premiums being charged for secondary coverage, the lack of support for the premiums, the lack of underwriting, an ultralow probability of any claims ever being paid by the pool under the terms of the policy, the poor drafting and confusing language of the policies, the Avarahamis' own testimony as to what they believed was the maximum exposure, and the Tax Court's concern with payments of a circular nature all caused the Tax Court to conclude that Pan American was not a bona fide insurance company.

The *Avrahami* decision demonstrates the importance for a captive insurance company to properly distribute its risks whether through the issuance of many insurance policies covering multiple independent risks or through a (re)insurance pool to meet the outside business test of the *Harper* case. An inadequate risk pool that fails to enable one captive to achieve risk distribution is likely to have the same effect on all the other captives participating in the risk pool. The IRS's victory in the *Avrahami* case can be expected to translate into an IRS victory against every captive participating in the Pan American "risk pool" because that pool failed to provide each participating captive with sufficient risk distribution.

**The Feedback Captive: Not Operated Like an Insurance Company**

After the Tax Court found risk distribution to be lacking in *Avrahami*, the Tax Court then proceeded to analyze whether Feedback was operated like an insurance company such that the arrangement looked like "insurance in the commonly accepted sense." While this was the order of the opinion's discussion, one cannot help but question whether it was the operational defects of Feedback discussed below that led to the Tax Court's holding to not respect the pooling arrangement in the first place.

The Tax Court concluded that Feedback was not operated like a bona fide insurance company, focusing on numerous factors, each discussed below:

**Organization, Operation, and Regulation of Feedback**

The Tax Court found that Feedback's operations were deficient. The Tax Court noted that Feedback dealt with claims "on an ad hoc basis." The few claims that were paid by Feedback were approved despite being filed late and inconsistent with the terms of the captive's policy. The Tax Court noted that Feedback received no claims from its 2007 inception until two months after the insureds' income tax audit commenced in March 2013.

The Tax Court further found that Feedback made investment choices that "only an unthinking insurance company would make." Feedback invested in illiquid long-term unsecured loans to related parties and failed to get the regulatory domicile's required preapproval for its loans, which were otherwise prohibited under the domicile's rules. For example, Feedback loaned $2.53 million (approximately 65% of its assets) to an entity named Belly Button Center LLC, which was owned by the Avrahamis' children but was controlled by Mr. Avrahami in his capacity as the manager of this entity. Neither principal nor interest was due pursuant to the promissory notes governing these loans for eight to ten years, during which time the interest accrued. This financial arrangement was uniquely defective and hardly approaching one that deserved the commercially reasonable moniker.

Furthermore, these loans were either insufficiently secured or were unsecured. To compound matters, much of the loan proceeds were promptly transferred directly from Belly Button's account to the Avrahamis' personal account just two days after Feedback "loaned" the money to Belly Button. The terms of these loans were clearly not commercially reasonable, especially taking into account the fact that Feedback's ability to pay its claims would have been significantly impaired if Belly Button was unable to repay such loans. The only significant asset owned by

Belly Button was approximately 27 acres in Snowflake, Arizona, purchased in 2007 for $1.96 million, with a $1.2 million loan received from Mr. Avrahami and the rest of the purchase price financed with a note payable to the sellers. Thus, Belly Button did not have sufficient equity to properly ensure that it had the ability to repay such loans.

The Tax Court also noted that Feedback failed to comply with St. Kitts insurance regulations, which provide that a captive insurance company "may not make a loan to or an investment in its parent company or affiliated persons without prior written approval of the Registrar, and any such loan or investment shall be evidenced by documentation approved by the Registrar." Feedback issued purported loans to both Orna Avrahami ($200,000 in 2010) and Belly Button Center, LLC ($830,000 in 2008 and $1.5 million in 2010). Feedback did not seek approval of these loans from the St. Kitts regulator until the Avrahamis began preparing for trial.

**Capitalization**

The Tax Court did not focus on this factor, simply finding that, because Feedback met the minimum capitalization requirements of St. Kitts, it was adequately capitalized. This finding is of little consequence in light of the Tax Court's rejection of Feedback's insurance operations, investment choices, and lending strategies. To be sure, the Tax Court's acceptance of the equity sufficiency of Feedback must be viewed in light of its rejection of the lending strategies.

**Valid and Binding Policies**

The Tax Court did not agree with the Avrahamis that the insurance policies issued by Feedback were valid and binding because those policies contained contradictory terms, citing the fact that the policies contained inconsistent terms that were indicative of both a "claims-made" policy (i.e., the claim must be reported during the policy period) and an "occurrence policy" (i.e., the claim must occur during the policy period). For example, despite the fact that certain policies issued by Feedback required that the insured notify Feedback of the *occurrence* of an event within the policy period, these same policies also referred to themselves as a "claims made" policies. While various types of hybrid policies are common in the insurance industry, here the Tax Court's concern was the internal inconsistencies of the Feedback policies.

According to the Tax Court, many of the policies issued by Feedback did not provide clear coverage terms and were vague as to the coverage triggers. For example, the business risk indemnity policy issued by Feedback to the insured real estate companies did not provide clear coverage terms. This policy covered any liability to a third party that resulted from an insured's business activity. However, the policy also excluded any event that the insured was aware of prior to the effective date of the policy period, which could be interpreted to extend to all of its business activities. The Tax Court ruled that it was unclear precisely what coverage was being provided pursuant to the terms of the policies issued by Feedback, finding that Feedback did not issue valid and binding policies.

**Reasonableness of Premiums**

The Tax Court found that the premiums charged by Feedback were not reasonable, focusing on the fact that such premiums were not established as a result of an arm's-length transaction. The various facts that contributed to the Tax Court's finding that the premiums were unreasonable included the following:

- The actuary and underwriter (Rosenbach), who was hired to help price the Feedback policies, priced captive insurance policies only for Clark, who referred such captive clients to the actuary.

- Based on a representative email chain between the Avrahamis' actuary and Clark, the Tax Court found that Clark told the actuary each year that the Avrahamis had a "target premium" of $840,000 for their direct policies and a target premium of $1.2 million for total premiums[12] – the direct policy premium plus $360,000 in premiums for the terrorism insurance from the Pan American pool.

- The Avrahami entities were maintaining commercial coverage for less than $90,000 per year, while simultaneously paying Feedback and Pan American premiums just shy of $1.2 million per year.[13]

- The actuary appeared to be arbitrarily choosing inputs that would generate higher premiums to be paid to Feedback until he reached his goal of justifying a target of $1.2 million in total premium. The actuary would make adjustments to policy pricing without coherent explanation and would add in a "proration factor" or drop the policy limits until he reached his goal of arriving at a total target premium of $1.2 million to be charged by Feedback.

[12] Under §831(b), the underwriting income of a non-life insurance company is tax-exempt provided that its net written premiums (or, if greater, direct written premiums) for the taxable year do not exceed $1.2 million. Beginning in 2017, the annual limit was increased to $2.2 million and indexed for inflation for each tax year after 2017. As of January 1, 2018, the premium limit is $2.3 million.

[13] In the usual situation, this factor should be of little consequence since most captive programs are designed to handle a much broader range of coverages than are available through the commercial insurance markets. The aggregate premiums of the then existing commercial coverages say little of the expanded or enhanced risk management program with a captive arrangement in place.

The Tax Court concluded that the actuarial calculations for pricing the premiums to be charged by Feedback were not the result of actuarial sound decision-making and were aimed at justifying the total premiums to be charged by Feedback as close as possible to the $1.2 million target, without going over. At the end of the day, the Tax Court viewed the actuary in this case as being controlled by Clark rather than as an independent actuary who was using generally accepted actuarial standards.

**Payment of Claims**

Although the Tax Court noted that Feedback did pay some claims filed against Feedback for losses to the Avrahamis' insured operating businesses, the Tax Court emphasized that the Avrahamis' operating businesses only began filing claims against Feedback after the Avrahamis learned that the IRS was examining Feedback. The total amount of claims approved and paid by Feedback between December 15, 2011, and December 15, 2014 was $105,215. During this same time frame, Feedback was being paid approximately $810,000 in premiums annually by the Avrahamis' various insured businesses. The Tax Court viewed the small amount of claims being filed against Feedback as suspicious.

However, there is no requirement that insurance claims must bear a close relationship to premiums. By way of example, terrorism coverage has generated billions of dollars of premiums since 9/11 with few claims actually paid. This fact, however, does not make it any less of an insurable risk. Similarly, many persons have paid for a business or personal umbrella policy for decades without a claim, again dispelling the requisite of a relationship between claims and premiums. The same can be said with respect to health insurance premiums paid by persons in their twenties and auto insurance premiums paid in the case of most drivers.

After analyzing each of the above factors, the Tax Court held that Feedback was not operated like an insurance company and was therefore not "insurance in the commonly accepted sense."

**Lessons Learned from *Avrahami***

**Captive Planning Requires an Experienced Professional Team**

The innumerable taxpayer adverse facts that were present in the *Avrahami* case should have been addressed and resolved by an experienced professional team early on during the captive's planning and operational phases. As a matter of policy, for almost 100 years, the Code has favored the establishment of property and casualty insurers to promote businesses offloading their risks to a captive affiliate. However, to benefit from these specialized tax provisions, each of the four specific case law requirements (i.e., risk shifting, risk distribution, insurance risk, and common notions of insurance) must be satisfied for a company to be treated as insurance for federal income tax purposes.

An experienced captive professional team includes the following professionals and specialties:

- Underwriters, including Chartered Property Casualty Underwriters (CPCUs), Associates in Risk Management (ARMs), and Certified Insurance Counselors (CICs), who may in turn draw upon base information provided by actuaries with experience in pricing captive insurance policies and together establish a premium pricing model

- Claims adjusters

- Financing/banking lawyers

- Accountants, CPAs, and independent auditors

- Actuaries

- Corporate lawyers experienced in policy manuscripting

- A reasonable regulatory structure established in a domicile experienced in regulating captives

- A properly designed risk diversification mechanism

- State and federal tax lawyers

- Administrators, paralegals/operating personnel

Both the planning and operations of a captive should be implemented using a multidisciplinary approach, leveraging the expertise of professionals experienced in each of the areas listed above. The planning should be overseen by qualified professionals who are experienced in the legal aspects of the planning. Because a captive is a complex risk management vehicle, care should be taken at all levels of the planning and its implementation to ensure that it is formed and operated in a manner that is consistent with laws, regulations, and industry best practices. In *Avrahami*, the IRS found the “low-hanging fruit” that embodies its concern with captives being used for tax-motivated planning rather than as a legitimate risk management tool.

Captives operating pursuant to §831(a), §831(b), and §501(c)(15) benefit from federal income tax benefits favoring insurers. However, these benefits only exist for companies that meet the four requirements of insurance. These long-recognized concepts were lacking in *Avrahami*. The Tax Court's holding was not surprising based on the facts presented in this case. Lacking in this case was proper respect for all the elements that go into the design and operation of a bona fide insurance company. As a result, this case fell outside the boundaries of more than 30 years of well-established case law.

**Additional Pending Captive Insurance Cases**

There are pending cases that have been tried involving small captive insurance issues but that have yet to be decided, including *Caylor Land & Development, Inc., v. Commissioner*,[14] *Wilson v. Commissioner*,[15] *Syzygy Insurance Co., Inc., v. Commissioner*,[16] and *Reserve Mechanical Corp. f.k.a. Reserve Casualty Corp. v. Commissioner*.[17] *Reserve* involves a captive operating under §501(c)(15) and the other three cases involve captives operating under §831(b). Regardless of the applicable Code section, the four pillars of insurance are the same. Both *Caylor* and *Reserve* have been fully briefed by the parties and are awaiting a decision by the Tax Court.

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14 U.S. Tax Court Docket Nos. 17204-13 et al. (tried in May 2016).

15 U.S. Tax Court Docket No. 26547-13 et al. (tried in August 2016).

16 U.S. Tax Court Docket No. 2140-15 et al. (tried in December 2017).

17 U.S. Tax Court Docket No. 14545-16 (tried in April and May 2017).