Avrahami: Reviewing the Situation

John Dies and Steven Miller of alliantgroup analyse the Avrahami decision, and warn captives to take a look at their own programmes

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On 21 August, the US Tax Court issued its long awaited decision on Avrahami v Commissioner. After waiting nearly two and a half years from when the case was tried, the captive insurance industry finally has a little more clarity on how the tax court views certain captive insurance arrangements. While many had hoped for a wide-ranging opinion that provided captives with a clear path forward, the decision fails to offer truly strong guidance on how the Internal Revenue Service (IRS) or courts will view more common captive insurance arrangements. The facts present in Avrahami have led the court to issue a very fact-intensive opinion, which means taxpayers should be cautious when trying to extract general rules or holdings from the case.

The issue the court considered in this case is whether amounts paid to Feedback (the captive) and the Pan American Reinsurance Company were deductible as insurance payments for Federal tax law purposes. The government argued that Feedback's policies included uninsurable risks; that it failed to distribute risk because it had an insufficient pool of insureds; that risk was not shifted; and that the arrangements did not embody common notions of insurance because Feedback and Pan American did not operate like insurance companies and their premiums were not determined at arm's length. The court agreed with some of these arguments, but again, did so in a very fact-specific manner.

Let's start with the court's overall analysis. There is nothing surprising in its criteria as it started with Helvering v Le Gierse and its insurance-defining factors: risk shifting, risk distribution, insurance in the commonly accepted meaning and the presence of insurable risk. Nothing new here. But then the court applied the facts to each. The court's first determination related to risk distribution. Here, it focused on whether Feedback met risk distribution through insuring either affiliated entities or unrelated parties under the Pan American programme. While the court held that risk distribution was not met through insuring either related or unrelated entities, we think it made two important points.

First, it did not opine on the number of related entities needed to meet risk distribution. While the government's expert stated that 35 sibling entities would constitute a good distribution of risk, the plaintiff's expert, citing Revenue Ruing. 2002-90, stated that only 12 were needed. In the end, because Feedback insured only three to four related entities, the court did not opine on whether the appropriate number was 12, 35, or somewhere in between. It only said that what was present was not enough.

Second, the court held that risk distribution was not met through the Pan American pool programme. It did so by looking at the seemingly circular flow of funds, unreasonable premiums, and a lack of arm's-length dealings. What is important here is that the court did not prohibit or even speak negatively of risk pools, but instead focused on the totality of the facts, adding to the above such negatives as "utterly" unreasonable premiums charged for terrorism coverage, the unlikelihood of claims, and thin capitalisation of Pan American. This last point was fascinating in that the court found that by not retaining some funds, Pan American would be unable to meet claims. The court also held that Pan American was not a fronting company, due in part to the fact that the fee charged was a fixed fee and was not charged as a percentage of premiums. As a result of the court's methodology, we think it is vital for taxpayers to consider how their reinsurance arrangements compare to those in Avrahami, and whether these arrangements would meet risk distribution requirements.

Although the court found that the arrangement did not meet risk distribution requirements, it still analysed whether the arrangement constituted insurance in the commonly accepted sense. The answer was no. The court analysed whether the company was organised, operated, and regulated as an insurance company; whether it was adequately capitalised; whether policies were valid and binding; whether premiums were reasonable and at arm's length; and whether claims were paid. It found that, in totality, the arrangement didn't add up to insurance in the commonly accepted sense. Key factors that the court focused on include:

- No claims until initiation of the IRS audit
- Operations and formalities were lacking
- Claims were dealt with on an ad hoc basis
- Policy terms were unclear
- Investments in illiquid assets such as long-term loans to related parties
- Failure to receive regulatory approval for loans

The court also spent considerable effort in analysing the work of the actuary. In this regard, the court had harsh terms for the taxpayer's actuary, stating that his explanations "were often incomprehensible" and that "the premiums were utterly unreasonable". We believe that there are a few key takeaways from the court's actuarial and policy analysis. First, because of the emphasis on clarity in language of each policy, it is important for policies to be unambiguous and discernibly either claims-made or occurrence based. Second, it is vital that a captive operates as a normal insurance company in terms of operations. Specifically, having a valid claims-handling policy, and actually adhering to such policies, is crucial. Third, since the court will focus on the details of the actuary's methodology, it is necessary to have a well-qualified actuary to review, understand, and be comfortable with his/her methodology.

Two taxpayer-favourable outcomes also resulted from the opinion. First, the court abated all section 6662(a) penalties for the taxpayer. The only penalties assessed were a result of the Avrahamis' failure to report dividend income. The court held that penalties should not otherwise be assessed because the Avrahamis had reasonable cause and acted in good faith, and also relied on the advice of a professional—their estate and tax planning attorney. This finding seems a stretch based upon the facts, but may be more a result of the court's view that it could not impose a penalty where no guidance existed. Second, the court held that it did not need to decide on economic substance, substance over form, or the step transaction doctrine, which is something that the IRS has been arguing in exams of captive insurance companies. Nor did the court need to speak to risk shifting or insurable risk. These issues will remain untouched.

While this decision was not favourable to the Avrahamis, there is a long way to go. First, the case is very fact specific. Second, the case does not cover all issues. Third, we suspect the case may be appealed. While we now know that the tax court has a very unfavourable view of certain facts, the Avrahami decision is seemingly isolated to those unfavourable facts. We do, however, think that based on the facts the court focused on, it will be vital for all captives to undergo an immediate and thorough review of their programme, and to implement immediate changes.

About authors:

Steven T. Miller served as former IRS Acting Commissioner in 2012, but prior to that he served for several years as the Deputy Commissioner for Services and Enforcement, leading all IRS enforcement and service activity. Steven also served as the Commissioner of the Large and Mid-Size Business Division, overseeing IRS audits of large taxpayers and the IRS programs relating to offshore tax compliance and international tax law enforcement. As the Commissioner of the Tax Exempt and Government Entities Division, he supervised the IRS oversight of governments, tax exempt entities and retirement programs.

In a career devoted to government service, Steven has spent the last 25 years with the IRS, serving the agency in a number of diverse and increasingly important roles.

John Dies is Managing Director of Tax Controversy at alliantgroup. As an experienced trial attorney and former partner in a litigation firm, he has represented hundreds of clients and tried cases to verdict throughout the United States. John specializes in rehabilitating audits where a taxpayer requires assistance after the IRS or other taxing authority announces its intent to issue a total disallowance or other negative result.