



A SILVER LINING

in the Tax Court Decision Against 831(b) Captive

Written by Karrie Hyatt

In August, the United States Tax Court released its decision in the case of *Avrahami v. Commissioner*, a highly anticipated case regarding captive insurance companies electing to use Section 831(b) of the U.S. Tax Code. While the case was decided against the owners of an 831(b) captive, the decision can serve as guidance to other micro captives using the designation. While the ruling focused narrowly on specific points regarding the captive's circumstances, questions remain on the long-lasting affecting the industry.

The *Avrahami* case revolved around small business owners Benjamin and Orna Avrahami and their St. Kitts-domiciled captive, Feedback, established in 2007. The Avrahami's businesses consisted of several jewelry stores and real estate holdings based in Arizona. Ostensibly, the captive was formed to protect against terrorism risk. For federal income tax purposes, Feedback filed as a domestic corporation electing to take the 831(b) tax election.

The Internal Revenue Service (IRS) considered Feedback's tax filings as a micro captive as invalid and issued a notice of deficiency for nearly \$2.5 million in taxes and penalties for taxes filed in 2009 and 2010.

The Avrahamis brought the issue to the U.S. Tax Court in early 2015 claiming that Feedback was a valid insurance company and was in compliance with Internal Revenue Code (IRC) 831(b). The IRS argued that the arrangement of their captive was only for federal tax purposes—to provide substantial tax deductions—not actually insuring the businesses owned by the Avrahamis.

Federal Tax Code Sec. 831(b)

Referring to these small to medium-sized companies as “micro captives,” the IRS has been investigating small captive insurers that opt for the 831(b) election for more than five years. The agency suspects that some companies claiming to be captive insurers are really using the 831(b) designation as a tax dodge, especially in regards to estate planning and wealth transfer.

Captives taking the 831(b) election must be insurance companies, just like any other alternative risk transfer vehicle, and opting for the designation can offer certain tax incentives. The micro captives sector has been growing exponentially in the last decade, with a number of state domiciles specializing in their formation. As more and more small to medium-sized companies form captives and elect to take advantage of the Federal Tax Code, these smaller captives have gained criticism stemming from three main issues: some may seek to use them for tax shelter purposes; there have been a number of “promoters”

engaging in setting up captives who may not have a background in insurance; and some have been used for substantial estate tax avoidance or wealth transfer planning.

For the last three years the IRS has named micro captives to their “Dirty Dozen” list—a list the agency releases each year warning tax payers of potential tax dodges and scams. Last November, the IRS issued Notice 2016-66, which named micro captives as “transactions of interest,” and required additional financial disclosures from captives opting for the 831(b) election for the purpose of gathering further data on how these captives operate.

The captive industry has been vocal in opposing the IRS’s one-size fits all approach towards micro captives. While industry leaders acknowledge that some promoters may be using the 831(b) option for non-insurance purposes, there are hundreds of captives using the election as it was intended.

The Avrahami Decision

On August 21, 2017, Judge Holmes of the U.S. Tax Court decided in favor of the IRS in the case of Avrahami vs. the Commissioner. He held that the transactions of Feedback and Pan American Reinsurance Company, Ltd.—a company used by Feedback for their risk distribution program—did not qualify as insurance companies. Therefore, the court concluded that Feedback was not eligible for the 831(b) tax deduction. However, it is important to note that the court ruled against imposing penalties in the case.



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Decision's Aftermath

Reaction to the decision among industry insiders was swift—most commending the decision. While those in the captive industry object to the measures the IRS has taken against 831 (b) captives, they do acknowledge that there are a few promoters that are using the election for something other than insurance. However, the overall objection by the industry is what is seen as an effort by the IRS to negatively single out a large section of captives for extra scrutiny. The Tax Court's decision, written specifically to the circumstances of the Avrahami family and Feedback, has been supported industry wide.

The Self-Insurance Institute of America, Inc. (SIIA) has been active in monitoring this case from the beginning, submitting an amicus brief in the case to inform the Court about the effectiveness of legitimate pooling entities.

Regarding the decision, in a statement, SIIA said that, *“The Federal Tax Court’s ruling in Avrahami is consistent with SIIA’s long time message. The fact pattern presented in the case is not characteristic of SIIA members and the best practices that we support.”*

According to Les Boughner, chairman of Advantage Insurance Management, “It is a classic case of how not to structure a captive. It really is not precedent setting in any respect. There are several well documented [private letter ruling’s] validating the use of good risk pools that appear validated by the ruling.”

Jeffrey Simpson, with law firm Gordon, Fournaris & Mammarella, said, “The Court’s analysis was fact intensive, and the Court in this case was moved by a number of features of the pooling facility that are not present in many other pool designs.”



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"While the court's decision is understandable, the ruling does not address a number of issues currently faced by the industry," said Ryan Work, vice president of government relations with SIIA. "There are many lessons to be learned from the Avrahami case, and the decision will certainly help foster better captive practices. However, at the end of the day, it does little to advance needed guidance on other outstanding captive policy issues, from the PATH Act to Notice 2016-66."

In the aftermath of the decision, the consensus among captive advocates is for small captives filing as an 831(b) to revisit their pooling arrangements to be certain that risk distribution meets industry standards.



Jeff Simpson

According to Simpson, *"Unfortunately, some operators who may have thought they were doing the right things are learning that they may have to change their ways or exit the industry. But there are many operators who can comfortably say the structures they work on have very few facts in common with the negative facts spotlighted by the Court. Those operators may actually feel more comfortable now."*

"This is an important first step toward the industry's getting the guidance it needs to move forward constructively," continued Simpson. "It doesn't address all of the pieces of the puzzle, and I don't think anyone imagined it would. But it does give us something concrete to work with." ■

Karrie Hyatt is a freelance writer who has been involved in the captive industry for more than ten years. More information about her work can be found at: www.karriehyatt.com.



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