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IRS Obtains Favorable Ruling in Captive Insurance Case

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BY

Taxpayers with established captive insurance companies, or those considering such arrangements, should take notice of a recent Tax Court decision denying a captive insurance company's election to be treated as a small insurance company under Section 831(b) of the Internal Revenue Code (the "Code"). The decision in *Avrahami v. Commissioner* may pave the way for the Internal Revenue Service (the "IRS") to escalate its attacks on captive insurance arrangements.

By way of background, a captive insurance company is an insurance company formed to insure the risks of a group of related operating entities. Once established, the captive insurance company functions just like any other commercial insurer by issuing policies, collecting premiums, and paying claims. Like other insurance companies, a captive is licensed as an insurance company in the domicile where it is formed. A key difference is that, unlike other insurance companies, a captive offers insurance only to companies within the family group and not to the public.

Business owners have compelling tax and non-tax reasons to consider captive insurance arrangements. First, under Code Section 831(b), captives meeting certain requirements can elect to be taxed only on their investment income and not on their underwriting profits. In addition, premiums paid by the insured operating companies to a captive may be deductible as insurance expenses. A captive can also be used to stabilize insurance budgets, reduce insurance administrative costs, and even serve as an estate planning vehicle.

Captives have historically been of interest to the IRS and have been viewed as a sham to create tax-deductible reserves in the captive when none could be created in the operating company. In late 2016, the IRS issued Notice 2016-66, which designates certain captive insurance companies that have made the Section 831(b) election as "Transactions of Interest," thus triggering extensive disclosure requirements for owners of captives that fall within the purview of the Notice.

On August 21, 2017, the IRS landed a victory in the Tax Court. In the *Avrahami* case, the taxpayers owned several shopping centers and jewelry stores, and established a captive to insure these businesses. The captive filed an election to be taxed as a small insurance company under Code Section 831(b). Premiums were paid to the captive, and the operating entities claimed deductions for insurance expenses. However, during the years in question, no claims were filed on the policies issued by the captive, and the operating entities continued to purchase insurance from third-party carriers, making no changes in coverage.

The IRS challenged the deductions for the premiums paid to the captive, and the Tax

Court ruled against the taxpayers. First, because the captive insured only a handful of related businesses, there was insufficient risk distribution to establish true insurance. In addition, the premiums charged were determined to be commercially unreasonable, and the captive made certain business decisions that were deemed imprudent, such as making unsecured loans to related parties. Finally, the fact that no claims were filed and that the taxpayers continued to purchase insurance from third-party providers was further evidence that the arrangement did not constitute true insurance in the commonly accepted sense. The Section 831(b) election was ruled invalid, and deductions for premiums were denied.

Make no mistake, the *Avrahami* case is not good news for captive insurance companies. However, the opinion doesn't really tell us anything we didn't already know. When scrutinizing a captive arrangement, what the IRS wants to see is a real insurance company acting like a real insurance company. What the IRS does not want to see is a thinly capitalized corporate shell masquerading as an insurance company so that a tax deduction is artificially created without any real risks actually being underwritten. The *Avrahami* case does not in any way hold that all captive arrangements are rendered invalid. It merely reinforces the IRS's position that it will aggressively challenge shams.

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