Avrahami v. Commissioner, 149 T. C. No. 7 (2017)

In Avrahami v. Commissioner, the U. S. Tax Court ruled that payments made by the Avrahamis' businesses to their microcaptive insurance company, Feedback Insurance Company, Ltd. , were not deductible as insurance premiums for federal tax purposes. The court found that Feedback's arrangements lacked sufficient risk distribution and did not meet the common notions of insurance, despite being structured to take advantage of tax benefits under section 831(b). This decision impacts the legitimacy of similar microcaptive insurance strategies used for tax planning.

Parties

Benyamin and Orna Avrahami (Petitioners) were the plaintiffs in the case, challenging the Commissioner of Internal Revenue's (Respondent) determination of tax deficiencies and penalties for the tax years 2009 and 2010. Feedback Insurance Company, Ltd. , owned by Orna Avrahami, was also a petitioner, with its own challenge to the Commissioner's determination regarding its tax status and elections.

Facts

The Avrahamis, successful business owners, owned several entities including American Findings Corporation, which operated jewelry stores, and several real estate companies. In 2007, upon recommendation from their long-time CPA and estate-planning attorney, they formed Feedback Insurance Company, Ltd. , in St. Kitts to provide insurance coverage to their businesses. Feedback sold various direct policies to the Avrahamis' entities and also participated in a risk-distribution program with Pan American Reinsurance Company, Ltd. , to reinsure terrorism insurance risks. The Avrahamis' businesses deducted significant amounts as insurance expenses for payments to Feedback and Pan American, claiming these were ordinary and necessary business expenses under section 162 of the Internal Revenue Code. Feedback elected to be treated as a small insurance company under section 831(b), which allowed it to be taxed only on its investment income, not its premiums. The Commissioner challenged these deductions and elections, asserting that Feedback's arrangements did not constitute insurance for federal tax purposes.

Procedural History

The IRS initiated audits of the Avrahamis' and Feedback's tax returns for 2009 and 2010. The Commissioner issued a notice of deficiency to the Avrahamis, disallowing the insurance expense deductions and recharacterizing certain transfers from Feedback as taxable income. Feedback received a separate notice of deficiency challenging its tax status and elections. Both parties timely petitioned the U. S. Tax Court, which consolidated the cases for trial. The court applied a de novo standard of review.

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Issue(s)

Whether the payments made by the Avrahamis' businesses to Feedback Insurance Company, Ltd. , and Pan American Reinsurance Company, Ltd. , constituted deductible insurance premiums under section 162 of the Internal Revenue Code?

Whether Feedback Insurance Company, Ltd. 's elections to be treated as a domestic corporation under section 953(d) and as a small insurance company under section 831(b) were valid for the tax years 2009 and 2010?

Whether the transfers from Feedback to the Avrahamis and their related entities were properly characterized as loans or as taxable distributions?

Rule(s) of Law

"Insurance" for federal tax purposes requires risk-shifting, risk-distribution, insurance risk, and conformity with commonly accepted notions of insurance. *See Helvering v. Le Gierse*, 312 U. S. 531 (1941). Section 162(a) of the Internal Revenue Code allows deductions for ordinary and necessary business expenses, including insurance premiums. Section 831(b) provides an alternative tax regime for small insurance companies with net written premiums not exceeding $1. 2 million, taxing them only on investment income. Section 953(d) permits a controlled foreign corporation to elect to be treated as a domestic corporation for federal tax purposes if it qualifies under parts I or II of subchapter L.

Holding

The court held that the payments to Feedback and Pan American did not constitute insurance premiums deductible under section 162(a) because they lacked sufficient risk distribution and did not meet commonly accepted notions of insurance. Consequently, Feedback's elections under sections 953(d) and 831(b) were invalid for 2009 and 2010. The court also held that certain transfers from Feedback were taxable as ordinary dividends, not loans.

Reasoning

The court analyzed the four criteria for insurance: risk-shifting, risk-distribution, insurance risk, and commonly accepted notions of insurance. It found that Feedback's arrangements failed to distribute risk adequately through either its direct policies to the Avrahamis' businesses or its participation in the Pan American program, which was deemed not a *bona fide* insurance company due to its circular flow of funds, unreasonable premiums, and lack of arm's-length transactions. The court also determined that Feedback's operations did not align with commonly accepted insurance practices, as evidenced by its handling of claims, investment in illiquid loans to related parties, and failure to adhere to regulatory requirements. The premiums charged by Feedback and Pan American were found to be unreasonable and not actuarially sound, further undermining their insurance status.

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The court applied these findings to invalidate Feedback's tax elections and to recharacterize certain transfers as taxable income to the Avrahamis.

Disposition

The court sustained the Commissioner's disallowance of the insurance expense deductions and invalidated Feedback's elections under sections 953(d) and 831(b) for 2009 and 2010. It also recharacterized certain transfers from Feedback as taxable ordinary dividends to the Avrahamis, subject to penalties under section 6662(a) for the unreported income.

Significance/Impact

This case marks the first judicial examination of microcaptive insurance arrangements under section 831(b), setting a precedent that such arrangements must meet stringent criteria to qualify as insurance for tax purposes. The decision underscores the IRS's increased scrutiny of microcaptive transactions and may impact the use of similar strategies for tax planning. It also highlights the importance of risk distribution and adherence to insurance industry standards in determining the validity of captive insurance arrangements.

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