



August 25, 2017

Summary of Avrahami Tax Court Decision Filed August 21, 2017

Tax court decision: The United States Tax Court denied deductions for premiums paid to off-shore insurance companies, and determined, among other things, that elections under IRC Section 831(b) were invalid, as the amounts paid did not qualify as insurance premiums for federal income tax purposes.

Background: The taxpayers implemented a captive insurance company in St. Kitts in 2007. They paid the premiums for some coverages directly to their captive. They also bought terrorism insurance from a fronting company that operated as a risk pool and reinsured to the captive a portion of the terrorism premiums collected by the risk pool. The fact pattern for this case is not indicative of how compliant captive insurance companies are currently structured or managed.

Key Points:

1. The Avrahami case has been a long time in the making. There was a lot of speculation about what the Tax Court finding might entail. Now that we have a decision, the captive industry is no longer in limbo.
2. The Court found that the captive's direct insurance arrangement fell short on risk distribution, as it failed to meet the minimum requirements for a valid structure.
3. The Court concluded that the terrorism coverage was drafted in a manner that made claims highly unlikely. For this and other reasons, the Court also found that the risk pool was not a bona fide insurance company, so the captive could not rely on the pool for risk distribution.
4. The Court further determined that the arrangement did not constitute insurance in the commonly accepted sense. In reaching this conclusion, the Court found, among other things, that the pricing was not realistic, claims were not made until after an audit was initiated, the claims that were made were not addressed in an orderly fashion, and the insurance policies were internally inconsistent.
5. Since the arrangement failed the requirements for risk distribution and insurance in the commonly accepted sense, the Court concluded it did not need to address risk shifting or the presence of insurance risk.

What this means for the industry:

1. This Tax Court decision is great news for the captive industry as it brings clarity to the use of 831(b) arrangements and helps highlight features of non-compliant programs.
2. Risk distribution is vitally important. Pools that do not constitute insurance in the commonly accepted sense will not provide risk distribution. Drafting coverage in a manner which precludes or eliminates meaningful actual claims is not insurance in the commonly accepted sense.
3. Maintaining a plan with no claims experience is a problem. From 2007 through 2013 there were no direct claims filed with the captive and no claims in the risk pool despite approximately 50-75 clients in the arrangement.



4. Claim review and payment methodology will be scrutinized. Ad hoc claims treatment and inconsistent review and/or approval procedures are problematic.
5. The Court will criticize a lack of actuarial experience and inappropriate or unexplainable pricing or methodology.
6. Captive arrangements can increase the probability of success by incorporating the use of independent advisors including tax advisors, legal counsel, actuaries, risk managers, and captive managers.
7. Arms-length, bona fide arrangements and transactions must be utilized.
8. Adhere to capitalization requirements as instructed by domicile regulators.
9. Loans should not be encouraged.

The Avrahami decision is insightful for those in the industry who seek to conduct their captive insurance practices in a compliant manner. The decision reinforces, among other things, the need to abide by structured, responsible and meaningful claims practices and procedures; and that risk pools provide adequate 3rd party risk distribution only when they look and work like insurance. It provides additional clarity and reaffirms many of the best practices employed by Oxford Risk Management Group.

It is beneficial to have further guidance from the Tax Court and this decision provides a clear picture of what “not to do” when structuring and managing a micro-captive arrangement. This case reinforces Oxford’s adherence to compliant captive arrangements.