



CRA Announcement

Insurance Economics

CRA Charles River
Associates

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CRA consultants help IRS win key § 831(b) captive insurance dispute

CRA consultants provided expert testimony and consulting assistance to attorneys with the IRS's Office of Chief Counsel in their successful efforts in the *Avrahami, et al. v. Commissioner* tax dispute.

Background

In late 2007, Benyamin and Orna Avrahami established a captive insurance company (Feedback Insurance Company, Ltd., domiciled in St. Kitts) to provide certain specialized coverages for their jewelry stores and real estate operations located in the Phoenix, AZ area. The IRS investigated and disallowed the deductions for premiums paid under the Avrahamis' captive insurance programs for the 2009 and 2010 tax years—over a million dollars in each year. The IRS disallowance was based on positions that some of Feedback's policies were for uninsurable risks and that the arrangements did not embody common notions of insurance. The Avrahamis argued that everything complied with US tax code and case law.

Feedback was established as a US domestic corporation for federal income taxes under I.R.C. § 953(d) and was taxed as a small insurance company under I.R.C. § 831(b), which allows insurers with \$1.2 million or less in premium revenues per year to be taxed only on investment income, not premium revenue. Advisors to the Avrahamis drafted contracts where Feedback would "insure" the Avrahamis' stores and real estate operations against certain events not covered by standard commercially available business insurance policies. The advisors also established and managed "risk distribution" programs that purportedly arranged for Feedback to insure enough risk not associated with the Avrahamis to qualify the premiums paid to Feedback as tax deductible expenses under IRS regulations. Under these conditions, the Avrahamis

deducted premiums paid to Feedback by their businesses, but Feedback did not pay taxes on the premium revenues due to the § 831(b) election.

The Court Opinion and expert testimony at trial

In a Tax Court Opinion released on August 21, 2017, [149 T.C. No. 7](#), Judge Mark V. Holmes found the testimony of CRA Senior Advisor [Professor David F. Babbel](#) “credible” and his “insight instructive and a good reasonableness check.”

In the five-day trial in March 2015 before Judge Holmes in Phoenix, Prof. Babbel explained the workings of the Avrahamis’ captive insurance programs and compared them to common notions of insurance. Mark Meyer, assisted by Matthew Phillips, served as a consulting expert for the IRS.

While captive insurance companies can be useful structures for corporations to lower their overall cost of risk because they internalize moral and morale hazard as well as focus efforts and responsibility for the management of risk, Prof. Babbel demonstrated that Feedback’s operations were more aligned to a wealth management, estate planning, and financial asset protection device rather than an insurance company. Ultimately, as Prof. Babbel explained, there was a complete circular flow of funds from the Avrahamis’ operations to Feedback and then back to the Avrahamis. Unlike standard insurance where companies would want to minimize the expected total cost of risk, the Avrahamis and their advisors targeted certain levels of premium (often, just below \$1.2 million) to put into the program.

Prof. Babbel showed that coverages offered by Feedback to the Avrahamis’ retail and real estate operations entailed such high levels of moral and morale hazard that no insurer would cover the operations except with extremely stringent limitations – which were absent. While there were no claims made against the Feedback coverages until the IRS started its investigation, Feedback’s premiums were extremely high – 10 times the amounts that the Avrahamis’ operations paid for standard commercial business insurance that covered the most common risks.

The Avrahamis used the assets of Feedback to provide over \$2 million to purchase properties via unsecured promissory notes, without obtaining regulatory approval, and thereby degrading Feedback’s ability to pay on claims. The risk distribution vehicle used insured against certain terrorism-related events with conditions that were extremely unlikely ever to occur (i.e., a federally declared terrorism event but only in cities with a population of less than 1.5 million). The premiums charged for the terrorism risk coverage were 80 times higher than the Avrahamis’ standard commercial terrorism coverage. The terrorism insurance carrier was domiciled in St. Kitts, reinsured 100% of all coverage issued, had extremely weak capitalization, and remitted all premiums received from the Avrahamis’ operations back to Feedback as reinsurance premiums within six months.

Prof. Babbel and CRA’s work in the *Avrahami, et al. v. Commissioner* matter is the second decision on the tax elements of insurance this year where the work has been cited in the

decision. For the prior decision in July 2017, please see the CRA announcement on the [U.S. v. Crithfield & Donaldson](#) matter.

To learn more about the CRA Insurance Economics Practice's expertise in captive risk insurance, or insurance and risk matters in general:

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