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The long awaited Avrahami case, the first section 831(b) case to be litigated, has finally been released and the US Tax Court has ruled in favor of the IRS. The IRS's position was that the premiums paid were not tax deductible because the arrangements lacked all 4 criteria necessary to be considered insurance for tax purposes, specifically:

1. The policies covered items not considered to be insurable risks
2. The overall arrangement failed to have the appropriate level of risk distribution
3. The arrangement failed to shift risk from the insureds due to the pricing of the underlying policies
4. The arrangement failed to follow the commonly accepted notions of insurance

Note that the Tax Court determined that because they found the failure to distribute risk and the fact that the arrangement failed to respect the commonly accepted notions of insurance including appropriate investments for an insurance company and requesting approval from the regulators to make related party loans, it was unnecessary to rule on the other 2 criteria.

Risk Distribution

The failure to have risk distribution in their determination that the reinsurance pool designed to provide risk distribution resulted in the reinsurance company be ruled as "not a bona fide insurance company" for Federal income tax purposes. The ruling did provide a list of factors that were used to determine whether an entity is a bona fide insurance company. We have examined these factors and determined that ERS Insurance satisfies most and to some extent all of the factors listed. We believe that ERS Insurance would therefore be respected as a bona fide insurance company for Federal income tax purposes. As a result, the portion of premiums that flows through ERS Insurance would meet the requirements of Risk Distribution.

Insurance in the Commonly Accepted Sense

The IRS argued that the captive was organized solely for tax purposes, didn't operate as an insurance company, lacked adequate premium determination, had unapproved related party transfers, didn't comply with the regulatory environment of the insurer's domicile, and issued policies with contradictory provisions.

At ERS, we manage our captives differently, and with the intent to respect the regulatory requirements of our domicile. Premiums are determined using actuarially derived rates, all captives undergo substantial underwriting review before formation, all related party transactions are pre-approved and all policies are clear, concise, and approved by our domiciliary regulators. We also write all coverages through our fully licensed, appropriately capitalized domestic insurance company. When our clients wish to invest in related party loans, all transactions are pre-approved and subject to complete documentation and repayment provisions, but we always strive to ensure that the captives under our management retain the capacity to pay whatever claims may come due.

While the result in this case was a win for the IRS, it did point out a number of facts that were detrimental to their taxpayer's position, which provides substantive guidance for others in the captive insurance industry. At ERS we have always strived to put together an insurance program that was second to none, which we constantly evaluate, and we will continue to improve where possible in the future.

We sincerely appreciate your trust in us as your service providers.

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