Aftermath: IRS & Private Litigation In Captive Insurance Companies

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In this article, Cantley and Dietrich discuss two recent Tax Court opinions and their implications for section 831(b) captive insurance companies.

Over 15 years ago, promoters and life insurance agents seized on a little-known provision of the IRC called section 831(b). Captive insurance company (CIC) transactions using the section 831(b) election began a meteoric rise to prominence as an income tax and estate planning technique. Many of those transactions complied with the law, but some promoters were far less careful in their section 831(b) CICs. The promoters ran roughshod over codified doctrines of economic substance and business purpose. This article addresses two recent cases, *Avrahami*[1] and *Reserve Mechanical*,[2] and their implications for section 831(b) CICs.

A key common thread in those two Tax Court opinions is each CIC's failure to create proper risk distribution. *Avrahami* lays the groundwork for the *Reserve Mechanical* opinion to slam the door on the sham pooling arrangements common in industry.[3] Although the petitioners in *Reserve Mechanical* operate a CIC under section 501(c)(15) and most other cases involve CICs operating under section 831(b), the insurance standards remain the same. While many promoters continue their Kabuki theatre, the IRS progresses with its enforcement actions, including designation of these CICs as a transaction of interest (TOI). With every TOI (or listed transaction), the IRS travels a well-worn path that eventually leads to mass IRS and civil litigation.

Avrahami v. Commissioner

In *Avrahami*, the husband and wife taxpayers owned numerous entities primarily engaged in retail jewelry sales and commercial real estate investment. The taxpayers were introduced to captive insurance through their longtime CPA, who the IRS brief notes "had no insurance experience but understood the [taxpayers'] financials and income tax obligations, and the tax benefits of a micro-Captive insurance arrangement."[4] The IRS brief in the *Avrahami* case illuminates some of the arguments that the IRS appears likely to use as it litigates with taxpayers and promoters over perceived abusive transactions.

In the 105-page opinion in *Avrahami*, the Tax Court focused on specific actions that failed to meet the basic level of appropriate actuarial,

[1] *Avrahami v. Commissioner*, 149 T.C. No. 7 (Aug. 21, 2017).

[2] *Reserve Mechanical Corp. v. Commissioner*, T.C. Memo. 2018-86.

[3] Additional cases are pending that may further illuminate risk distribution failures and likely other as-yet-untried causes of action. *See, e.g., Caylor Land & Development Inc. v. Commissioner*, Tax Court Dkt. No. 17204-13 (tried May 2016), *Wilson v. Commissioner*, Tax Court Dkt. No. 26547-13 (tried Aug. 2016), and *Syzygy Insurance Co. Inc. v. Commissioner*, Tax Court Dkt. No. 2140-15 (tried Dec. 2017).

[4] Respondent's brief at 221 (citations omitted). The taxpayers initially declined to form a captive, finding the CPA's recommended promoter "too slick."

insurance, funding, and corporate requirements for an insurance company. To withstand even bare scrutiny, a CIC must look, act, and be regulated like an insurance company. A CIC is a regulated financial institution. If a CIC ceases to operate as an insurance company, it cannot stand up to challenge by state insurance regulators, the IRS, or any governmental authority.

The Tax Court opinion noted that the Avrahamis' CIC (Feedback) failed on several points. The insureds took out loans of about 65 percent of the CIC's assets that were insufficiently secured or were unsecured,[5] with funds passing through shell entities back to the CIC's owners. Also, records produced reflected that the client's lawyer directed the actuary to arrive at dollar-specific premiums that fit the client's targets. The semi-retired actuary couldn't articulate for the court how the premiums charged by the CIC were calculated and thus failed to follow generally accepted actuarial standards. The opinion commented that the possibility of a covered loss being triggered under the carefully designed terrorism risk pool was so low that the Avrahamis' actuary admitted that he did not know of any event in history that would have triggered coverage. Also, St. Kitts is a small domicile having little regulatory history or experience, unlike more common domestic domiciles. Despite all this, the CIC operated at odds with the St. Kitts regulatory requirements because it never obtained the required preapproval for loans.[6]

Lessons for the section 831(b) community: Among other conclusions, *Avrahami* made it clear that (1) preformation and ongoing corporate and insurance company formalities must be strictly observed, and (2) loan-back arrangements with the CIC's principals both were likely to invite IRS antiabuse and judicial antiavoidance doctrines.[7]

Despite *Avrahami*, repeated promoter abuses continue. Even though it set their sights on risk pooling — and a good portion of the court opinion was devoted to a discussion of Pan American[8] as an insurance company — the opinion did not lay waste to the pooling arrangement. Instead, *Avrahami* laid the groundwork for a future decision like *Reserve Mechanical*.

Reserve Mechanical v. Commissioner

Reserve Mechanical represents the next step in the IRS's continued attacks against promoter-led abuses in section 831(b) captive insurance companies. For over 15 years, promoters have encouraged a kind of circular cash flow that differs from the loan-back system in *Avrahami*. In *Reserve Mechanical*, the IRS exposed the fake risk distributions occurring in most captive pooling arrangements. Under insurance law, the captive looks more like taxable self-insurance unless the shifted risk is then distributed and pooled with other similar yet diverse pools of risk.[9] Promoters combined the "best of" loan-backs and risk pools to serve the IRS the latest circular cash flow opportunity.

In *Reserve Mechanical*, the partners of the insured, Peak Mechanical & Components Inc., ran a business providing and servicing equipment used in underground mining. Each was a 50 percent owner, and each was involved in multiple other companies related to the primary business of Peak. Peak cleaned equipment used in polluted mines, and its employees apparently had potential exposure to hazardous materials. Peak maintained various commercial insurance policies that guarded against liabilities both general and specific to the hazards encountered.

A business mentor recommended that the partners contact Capstone Partners LP. Capstone (also affiliated with the Feldman Law Firm LLP)

[5] *Avrahami*, 149 T.C. at 79-80.

[6] *Id*. at 43-44; *see also* n.41, quoting St. Kitts's Captive Insurance Companies Act of 2006, which states that "a captive insurance company may not make a loan to or an investment in its parent company or affiliated persons without prior written approval of the Registrar, and any such loan or investment shall be evidenced by documentation approved by the Registrar."

[7] Including circular cash flows, lack of bona fide debt, the step transaction doctrine, the sham transaction doctrine, the business purpose doctrine, the substance-over-form doctrine, and the economic substance doctrine (codified in 2010).

[8] Pan American Reinsurance Co. Ltd. was the entity formed by Celia Clark's children, a "courtesy director of insurance," and the wife of the owner and founder of Heritor Management Ltd. (the sister company captive manager). This entity was ultimately determined to not be an insurance company.

[9] Rev. Rul. 2005-40, 2005-2 C.B. 4; *see also Humana Inc. v. Commissioner*, 881 F.2d 247, 257 (6th Cir. 1989); and *Beech Aircraft Corp. v. United States*, 797 F.2d 920, 922 (10th Cir. 1986) ("'Risk distributing' means that the party assuming the risk distributes his potential liability, in part, among others.").

provided turnkey captive insurance formation and management services. Feldman Law Firm provided legal services to Capstone captive insurance clients. Capstone and the Feldman Law Firm were both run by Houston attorney Stewart Feldman. While still preparing the feasibility study, the partners filed for formation of Reserve Mechanical as a section 501(c)(15) CIC under the laws of Anguilla. Capstone received and reviewed tax returns and other diligence documentation from Peak and conducted an on-site visit with Peak in August 2008. Capstone issued a final feasibility study in August 2009, about nine months after the partners began Reserve's operation.

Capstone's risk pool, PoolRe, was an insurance company originally domiciled in the British Virgin Islands then redomiciled to Anguilla in 2009. Capstone managed PoolRe's operations and kept its books. During 2008 and 2009, 81.5 percent of the total premiums charged for direct written policies went directly to Reserve Mechanical as lead insurer, and 18.5 percent went to PoolRe as the stop-loss insurer. In 2010 the ratio was 80.1 percent to 19.9 percent. Because PoolRe's coverages were all excess coverages, PoolRe didn't have to pay out anything unless specific attachment points were triggered by Reserve Mechanical's claims payments.

PoolRe pooled its own premiums and required Reserve Mechanical and the captive insurance companies of some of Capstone's other captive clients to execute a quota share reinsurance policy, by which Reserve Mechanical and those other captives agreed to assume a share of PoolRe's losses. In the bargained-for exchange, Reserve received back the premiums that were paid by the operating businesses that were paying PoolRe directly.

In the Tax Court's opinion, Capstone provided the appearance of insurance while failing to meet many of the requirements of actual insurance. The court held that Reserve Mechanical could not adequately distribute risk by insuring Peak's related businesses — largely because their activities were characterized as "insignificant." The court distinguished the risk distribution schemes in *Reserve Mechanical* and *Avrahami* from more deliberate, large-scale distribution of risk.[10] Further analysis revealed that once risk was distributed to a sufficient number of unrelated parties, the transactions with those unrelated parties were considered "insurance transactions" for federal income tax purposes. PoolRe's insurance expert explained that the "pooled insurance risk of PoolRe is reinsured back to the Capstone captives on a proportional basis," which the court read as circular cash flows.[11]

The ultimate determination was that PoolRe failed to meet the standards of an insurance company capable of providing reinsurance and risk distribution; Reserve — while organized and regulated as an insurance company — failed to operate as a bona fide insurance company; and Reserve's transactions were not insurance in the commonly accepted sense. The failure of the promoter-led devil-may-care attitude toward substantive application of the law reaches its pinnacle.

Lessons for the section 831(b) community: The truth hurts. *Reserve* teaches the lesson that looking like a duck and quacking like a duck doesn't overcome the failure to walk like a duck. The IRS recognizes and attacks on two key failures involved in this case: (1) circular flow of funds, and (2) the pooling arrangement with a reserve company like PoolRe. Pooling and risk distribution are probably the areas of captive insurance law least understood by prospective captive owners.

Perhaps the most important question addressed by the court was whether Capstone's risk pool, PoolRe, provided adequate risk distribution to Reserve Mechanical. The court found that it did not. While this is not fully

[10] *See Rent-A-Center Inc. v. Commissioner*, 142 T.C. No. 1, at 24 (the court concluded that the captive assumed and pooled premiums for "a sufficient number of statistically independent risks" and achieved risk distribution because it issued policies for its affiliates that covered more than 14,000 employees, 7,100 vehicles, and 2,600 stores in all 50 states); and *Securitas Holdings v. Commissioner*, T.C. Memo. 214-225, at 26-27 (holding that the captive distributed risk effectively when it provided workers' compensation coverage for more than 300,000 employees, automobile coverage for more than 2,200 vehicles, and other coverage for more than 25 separate entities).

[11] For an in-depth analysis of the Tax Court's evisceration of Reserve Mechanical's promoter-led pooling, see Jay Adkisson, "Analysis of the IRS's Big Win Against Risk-Pooled Small Captives in Reserve Mechanical," *Forbes*, June 25, 2018.

determinative on the issue of risk pooling agreements, the court seems to be bracketing the target area with the "acceptable" (such as the facts in *Rent-A-Center* and *Securitas Holdings*) on the one side and the "unacceptable" (like *Avrahami* and *Reserve Mechanical*) on the other.

Captive Civil Litigation

Historically, the designation of a new TOI (or listed transaction) has resulted in a predictable domino effect of events leading to mass civil litigation. Generally, the promoters first attempt to reassure their clients by making light of the consequences of the pronouncement and seek to control the situation by taking care of all necessary filings. Second, the promoters are assigned material adviser numbers (if they did not already have them) as the IRS opens tax shelter promoter investigations into them. Next, the taxpayers in some large measure are audited by the IRS, leading to their incurring previously unplanned-for fees and expenses in defending the audit. Fourth, the IRS proposes adjustments to the taxpayer returns that undo the tax benefits and add substantial (often 40 percent) penalties, if the taxpayer has not completed a qualified amended tax return.[12] At this point, civil litigation ensues, often beginning with class action complaints being filed. We are aware of class action litigation being prepared against such promoters by one of the most successful tax shelter plaintiff law firms.[13] In Part II of this article, we will discuss the complaint that is being prepared, after the plaintiff's litigation counsel has completed and filed it. Tax litigation attorneys and CPAs should consider the need to advise their clients of the potential for the statute of limitations running on any claims the clients may have against improper advice from the promoters of noncompliant section 831(b) CICs. Advisers should also make their clients aware that they likely cannot rely on advice from promoters to avoid IRS penalties. The storm we predicted in prior articles has reached the shore.[14] Now that the IRS is in full stride in its section 831(b) CIC enforcement activities, taxpayers, promoters, and advisers must take account of the aftermath: significant numbers of IRS audits and class action litigation. ■

[12] For more information on qualified amended tax returns, see Dave Slenn, "Small Captive Insurance Program Exit Planning," LISI Asset Protection Planning Newsletter No. 374, Sept. 6, 2018.

[13] David R. Deary of Loewinsohn Flegle Deary Simon LLP in Dallas, Texas. Deary successfully recovered $850 million for his clients in settlements back in the mid-2000s from tax shelter promoters.

[14] *See* Beckett G. Cantley, "Relearning the Lesson: IRS Judicial Doctrine Attacks on the Captive Insurance Company Pre-Planned Tax Deductible Life Insurance Tax Shelter," 14 *Hous. Bus. & Tax L. J.* 179 (2015); Cantley, "Repeat as Necessary: Historical IRS Policy Weapons to Combat Conduit Captive Insurance Company Deductible Purchases of Life Insurance," 13 *U.C. Davis Bus. L. J.* 1 (2013); Cantley, "The Forgotten Taxation Landmine: Application of the Accumulated Earnings Tax to IRC Sec. 831(B) Captive Insurance Companies," 11 *Rich. J. Global L. & Bus.* 159 (2012); and Cantley, "Steering Into the Storm: Amplification of Captive Insurance Company Compliance Issues in the Offshore Tax Crackdown," 12 *Hous. Bus. & Tax L. J.* 224 (2012).