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YOUR MONEY

Small, Private Insurers Face Increasing Scrutiny on Avoided Taxes

Wealth Matters

By PAUL SULLIVAN JAN. 15, 2016

SHOULD a Phoenix-area jeweler be able to create his own private insurance company to cover his jewelry stores against possible terrorist attacks, specifically those “relating to radioactivity from a ‘dirty’ bomb or from nuclear fuel or nuclear waste”?

And should he be allowed to sell such terrorism policies to other small business owners who operate in large cities, even though the insurance he created openly states that it will not cover claims in cities with more than 1.5 million people?

The answer, the Internal Revenue Service said in a 422-page response, is no. The business owner’s lawyers said it was perfectly legal. A judge is expected to rule in the case this year.

That ruling may determine the future strategies of entrepreneurs and small-business owners who have set up their own insurance companies to cover all manner of risks, some against likely occurrences, others less so.

Establishing these so-called captive insurance companies, which are wholly owned subsidiaries of private companies, is perfectly legal where there

are legitimate insurance needs not covered by commercial insurance companies. Captives have become increasingly popular in the last decade because they greatly reduce affluent business owners' tax bills.

The premiums paid to the captive are tax-deductible. (The tax code has allowed premiums of up to \$1.2 million a year to be tax-free.)

Some small captives are coming under scrutiny when the insurable risks — many for things unlikely to happen or already covered more economically by commercial insurance — are being used as a way to sidestep taxes, since few, if any, claims are paid out. And the money paid into the captive can be transferred to heirs at greatly reduced tax rates.

The I.R.S. is using the captive set up by Benyamin and Orna Avrahami, the owners of the Arizona jewelry stores, to challenge the validity of some small captives. It is arguing in its brief filed in United States Tax Court that the couple should not be able to deduct the premiums paid to their captive insurer.

How many captives have exploited the tax rules is hard to know, because captives are regulated by individual states — as is any insurance company — and some, as in the Avrahami case, have incorporated themselves offshore, which gives them an added layer of secrecy.

Captives face other challenges as well. Congress included language in its 2015 appropriations bill that tightens the rules that grant people large tax breaks on the premiums they pay into these insurance companies. The rules take effect next year.

“What you’re going to see is a lot of people scrambling to understand what’s happening,” said David J. Slenn, a lawyer at Quarles & Brady in Naples, Fla., and the chairman of the American Bar Association’s captive insurance committee. “They’re going to have to fix the structure so in 2017 they qualify to make the election” to get a tax break on the premiums.

Concern about small captive insurance companies has been percolating since they landed on the “Dirty Dozen List of Tax Scams” published by the I.R.S. last year.

If the small captive doesn't pay out insurance claims, the money accumulates as it does in a commercial insurance company. The company could elect to pay dividends to the people who own the captive. In the abusive structures, lawyers and accountants say, the captives pay out little in claims and the people receiving dividends are the children or grandchildren of the people who set up the insurers.

While those dividends would be taxed, the rate would be far lower than the income tax rate that the business owner would have avoided in putting the premiums into the captive, and the money would go to the heirs without being subject to the much higher gift-tax rate.

In the appropriations bill, Congress set out to make this more difficult. At first glance, the appropriations bill seemed to give small captives a lift by increasing the tax-deductible premium in 2017 to \$2.2 million and indexing it to inflation.

But Congress then added two new requirements for small captives to prove that they were entitled to a tax deduction for the premiums. One requires that a captive prove that no more than 20 percent of the premiums come from one policyholder.

Jay D. Adkisson, former chairman of the A.B.A. captive insurance committee and a lawyer at Riser Adkisson, said captives owned by one person wouldn't be able to meet this standard. Policyholder is defined in such a way that all family members are treated as one policyholder.

The second new requirement prohibits an insured company from being wholly owned by one person and the captive by his or her heirs. And it limits the difference in ownership to 2 percent, Mr. Adkisson said. If, for example,

the insured company were owned 100 percent by the parents, their children could own only 2 percent of the captive.

“People are scrambling to understand that ownership rule,” Mr. Slenn said. “It can be pretty dangerous, and not just to those who are trying to abuse the transfer tax.”

There could, for example, be business owners who have used captives to pay claims but at the same time, on the advice of their accountants and lawyers, have named their children as the owners of the captive as part of an estate planning strategy. Or, Mr. Slenn said, there could be trusts that own the small captives as well as other assets, but it is the business owner’s children who are the ultimate beneficiaries. Still, in some situations, certain types of trusts may still work.

There is also no allowance for an existing captive to be grandfathered in under the new guidelines. If people don’t make changes this year, they could be subject to the taxes that a regular captive pays next year. A captive could also find itself responding to an I.R.S. investigation, litigation or penalties. Yet if the owners unwind the small captive, they could be hit with capital gains taxes on the premiums paid into the captive, Mr. Slenn said.

The I.R.S. has signaled in the Avrahami case that it may be stepping up its enforcement efforts. At the very least, the agency seems to be making an example of this couple, who took what the I.R.S. deemed aggressive steps in the construction of their small captive.

The couple enlisted Celia R. Clark, one of the lawyers in this field who has written about the estate tax benefits of captives. With her assistance, the couple created a captive with restrictions on the amount, manner and reason it would pay out claims. (It paid out a claim only after the I.R.S. began investigating it.) It also, the I.R.S. says in its brief, seemed to base its annual premium on the size of the tax deduction the couple needed for a given year and not on the price of the risk it was insuring.

“In one year, you have half the premium charged, when there hasn’t been any change in the exposures presented by the risk,” said Donald W. Bendure, a risk and insurance management consultant at Robert Hughes Associates. He recently criticized the Avrahamis’ captive on a call for American Bar Association members. “It really does have to make sense.”

Mr. Adkisson, on the same call, was even harsher in his criticism: “The formalities are followed, but they’re undone by email. Celia Clark, the owner of the company, the tax attorney and the C.P.A. are talking about a lot of issues where they make it pretty clear that what they’re trying to do is create Kabuki theater for the service so if the service takes a look, it looks like a real captive.”

Ms. Clark declined to comment. Tim A. Tarter, a tax lawyer in Phoenix who is the Avrahamis’ defense lawyer, said, “We believe the facts support a finding that this was set up the way it was intended — to insure risks that are not available commercially or to provide gap-type coverage.”

While tax planners are often aggressive on behalf of their clients, there are many other owners of small captives who will need to rethink what they have done.

“This is years of some bad practices finally coming to light,” Mr. Slenn said. “A lot of people are waiting to see what happens with Avrahami.”

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