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U.S. Tax Court: No deduction for amounts paid to captive insurance company

The U.S. Tax Court today issued an opinion finding that amounts paid by the taxpayers to a captive insurance company in 2009 and 2010 were not insurance premiums for federal income tax purposes and were not deductible.

The case is: *Avrahami v. Commissioner*, 149 T.C. No. 7 (August 21, 2017). Read the 105-page [opinion](#) [PDF 370 KB]

Summary

The Tax Court summarized today's opinion as follows: The taxpayers (husband and wife) owned three shopping centers and "three thriving jewelry stores" in Arizona. In 2006, the taxpayers spent a little more than \$150,000 insuring them. In 2009, this insurance bill was more than \$1.1 million and then in 2010, more than \$1.3 million. The court's opinion states that the taxpayers were paying the overwhelming share of these bills to a new insurance company that was wholly owned by the wife.

No claims were made on any of the insurance policies until the IRS began audits of the taxpayers' returns and of the returns of their various entities. The insurance company had accumulated a surplus of more than \$3.8 million by the end of 2010—\$1.7 million of which ended up back in the taxpayers' bank account as loans and loan repayments.

The taxpayers claimed deductions under section 162 on their 2009 and 2010 tax returns for amounts paid by their passthrough entities to the captive insurance company and to an off-shore company that reinsured a portion of its risk with the captive insurance company.

The IRS denied the deductions and determined that the insurance company's elections under section 831(b) to be treated as a small insurance company and under section 953(d) to be taxed as a domestic corporation were invalid because the

amounts paid did not qualify as insurance premiums for federal income tax purposes. The IRS also determined that amounts transferred out of the insurance company were distributions to the taxpayers—not loans—and that the taxpayers were liable for accuracy-related penalties under section 6662(a).

The Tax Court's opinion, generally upholding the deficiency determination, concludes that:

- The amounts paid to the captive insurance company and off-shore company were not insurance premiums for federal income tax purposes and were not deductible under section 162.
- The elections under sections 831(b) and 953(d) were invalid for 2009 and 2010.
- The amount transferred directly from the captive insurance company to the wife was an ordinary dividend.
- The amount transferred indirectly from the captive insurance company to the taxpayers was not taxable to the extent it was a loan repayment, but the excess was either taxable interest or an ordinary dividend.
- The taxpayers were not liable for accuracy-related penalties under section 6662(a) except in relation to the amounts determined to be ordinary dividends or taxable interest.

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