



Leading actuary Peter Johnson lays out key lessons from the Avrahami case

The Avrahami case centres around an Arizona jewelry and real estate company whose captive is domiciled in St. Kitts that was targeted by the IRS.

With a thorough investigation and evaluation of the marketing materials relied on by the Avrahami's, premium pricing, programme initiation and loss experience, as well as a series of interviews, the IRS commissioner ("commissioner") identified a range of issues with the Avrahami's captive, Feedback Insurance Company, Ltd. ("Feedback"), including:

- 1) **Risk distribution:** The commissioner argued that Feedback's policies included uninsurable risks and that it failed to distribute risk because it had an insufficient pool of insureds.
- 2) **Operations and premium:** Feedback and Pan American did not operate like normal

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insurance companies and the terrorism premiums were excessive.

Although the tax court summary for the Avrahami case ("court summary") specifically states that "The absence of risk distribution was enough to sink the Feedback" it identifies numerous other issues around Feedback and its reinsurer, Pan American, and at the end of the case the US Tax Court ruled in favour of the IRS, and against Avrahamis.

These issues raised are extremely helpful for the captive industry going forward as they illustrate key issues to consider in

start-up and ongoing operations of a captive. The lessons to be learned from the Avrahami case are as follows:

Lesson 1: Risk distribution is needed

Risk distribution is attained when the insurer pools a large enough collection of unrelated risks (Supreme Court in *Le Gierse*, 312 US at 539). As the court summary mentions, this idea is based on the law of large numbers.

Unfortunately, in Feedback's case, it was insuring only three affiliated entities in 2009 and four in 2010, which was well below the 12 affiliated entities threshold established in the 2002 ruling (Rev. Rule. 2002-90). The court summary also identifies that one must also consider the number of independent risk exposures and concluded that Feedback fell far short of the other court case examples where risk distribution was met.

Unfortunately, there currently is no bright line test for a captive to determine if the law of large numbers exists. A number of organisations are attempting to quantify and review appropriate standards of practice and have begun establishing benchmark criteria that meet this test.

Considerations in this assessment include, but are not limited to the following: number of coverages, correlation of risk, number of independent exposures, unrelated risk, captive coverage structure (including limits, retentions, reinsurance, and insurance versus business risk), etc. — all to minimise volatility.

Lesson 2: Avoid premium excessiveness and inconsistencies with commercial market premiums

Near the top of the list of issues pointed out in the court summary was premium excessiveness versus the commercial market. It was pointed out that the rate on line approach used by the Avrahami’s actuary in pricing out the terrorism coverage resulted in premiums that were “80 times more than the Jewelers Mutual Policy”.

Even after the court’s consideration of additional terrorism coverage (i.e., the coverage gap of the commercial market being insured) “the premiums charged by Pan American are grossly excessive”.

The Avrahamis went from paying \$150k in commercial premiums for its business coverage in 2006 to \$1.3m in 2010 with the inclusion of captive premium with a number of insurance lines not previously covered.

This equates to an increase in total premiums paid by the Avrahamis of almost 800%. The court summary also highlighted the Avrahamis had a “target premium” and premiums were adjusted to hit this target. There are several lessons to be learned here. These include the following:

- There should be a reasonable relationship between commercial market and captive premiums. This includes evaluating relationship of premiums for each coverage separately and in total for the captive.
- Premiums should be structured to fund realistic loss outcomes and pass risk transfer.
- Total captive premiums as a percentage of the limit should be reasonable

In helping to evaluate the relationship of total captive premium reasonability we

recommend performing a series of reasonableness tests. This includes performing an evaluation consistent with the idea of Total Cost of Risk (“TCOR”).

In short, this will help evaluate the reasonableness of captive premium to insured revenue ratios. There is industry benchmark information available, including RIMS data, to help make this assessment. For more information on TCOR, please see my earlier article written on the subject for *Captive Review* back in early 2014.

Lesson 3: Insurance contract should contain risk transfer and risk distribution

The court summary referenced the *Humana, Inc. v Commissioner* case of 1989 where “Risk transfer and risk distribution are two separate and distinct prongs of the test and both must be met to create an insurance contract”.

The idea of risk transfer is very important to actuarial pricing and accounting standards of practice that have been established. A premium should be sufficient to fund all

“The issues raised are extremely helpful for the captive industry”

captive expected loss costs and expenses, but there is a limit to how high premiums should be otherwise risk transfer tests will fail. Two industry accepted risk transfer tests are generally considered.

- 10-10 Test: 10% chance of an underwriting combined ratio of at least 110%; and
- Expected Reinsurance Deficit (ERD) Test: average underwriting loss of at least 1%

An understanding of these tests can help the captive industry ensure captive insurance contracts are designed in a way to transfer risk yet ensure premium funding will be there to pay for expenses and losses.

It is also important to understand it is difficult to defend the premium/rate making practices behind a pool, a group of captives managed by a captive manager, or a reinsurer (such as Pan American) if historical loss ratios are very low year after year.

The terrorism coverage pricing in Pan American is a good example since there were no claims filed, but the rate on line approach utilised combined with the number of captives being reinsured implied

multiple claims should have been filed every year.

Lesson 4: Act Like an insurance company

In order to qualify as a bona fide insurance company in the eyes of the court a captive should be able to answer “Yes” to each of these questions and provide adequate support:

- Was the captive created for non-tax business reasons?
- Is there no circularity to the flow of funds?
- Does the captive face actual exposures and insurance versus business risk?
- Are the policies developed in an arm’s length approach?
- Did the captive charge actuarially determined premiums?
- Was a comparable coverage in the market place more expensive or even available?
- Is the captive subject to regulatory control and did it meet minimum statutory requirements?
- Was it adequately capitalised?
- Were claims paid from a separately maintained account?

By answering yes to each of these questions the Avrahami’s would have had a much stronger argument in defending Feedback as a bona fide insurance company.

Other lessons learned from the issues pointed out in the case summary include:

- Conduct a feasibility study
- Hire an actuary to evaluate annual losses and pricing
- Have clear policies consistent with market norms
- Have plausible loss scenarios
- Have appropriate investment policies
- Be sure the insured’s claims are submitted and paid by the captive
- Consider adding employee benefits to your captive - Based on Notice 2016-66, captives that fund employee benefits subject to the Employee Benefits Security Administration of the US Department of Labor where it has issued a Prohibited Transaction Exemption, are not treated as an arrangement identified as a transaction of interest.

Being able to defend a captive’s position as a bona fide insurance company when answering each of these questions has been and will be very important going forward. The great news with all of this is there is an increased level of transparency to the captive industry through the court summary. 