The more things change, the more the IRS looks to blame

Rent-A-Center v Commissioner answered some questions, but posed others. Alan Fine of Brown Smith Wallace explains

In January 2014, the US Tax Court released its long awaited decision in Rent-A-Center v Commissioner, addressing the deductibility for federal income tax purposes of premium payments made by brother/sister entities to a commonly controlled captive insurance company. Although the case provides a good review of the litigation history between the IRS and taxpayers in the captive arena and answers some questions, it leaves other key issues open.

In a 10-6 divided opinion, the Tax Court upheld the deductibility of the premiums paid to the captive. This divided opinion, which included a concurring opinion and two dissenting opinions, is unusual given that most Tax Court opinions are generally written by a single judge.

Rent-A-Center (RAC), in response to dramatically rising risk management costs, was advised by Aon that a captive could provide many benefits, including reducing costs and improving its overall risk management. RAC then commissioned Aon to prepare a feasibility study addressing the financial and non-financial benefits of forming a captive, which was then analysed by an accounting firm.

In late 2002, RAC incorporated and capitalised its captive with $9.9 million (the feasibility study recommended the captive be capitalised with no less than $8.8 million). As part of its due diligence, RAC requested a fee quote from Discover Re for the coverages to be insured in the captive. Discover Re responded that it would not insure the coverage contemplated by RAC but estimated that the premiums it would charge would be about $3 million more than the premiums actuarially determined appropriate to be charged by the captive.

During the years in question, the captive wrote policies covering workers' compensation, automobile and general liability claims below that insured by Discover Re.

RAC paid the premiums on behalf of the insured subsidiaries and allocated them back to the subsidiaries through an intercompany payable. The premiums were based upon the actuarially determined amounts calculated by Aon.

During the first three years of the captive's existence, RAC guaranteed the deferred tax asset on the captive's balance sheet in order to meet the minimum solvency margin.

IRS: sham; Tax Court: no

The IRS attacked RAC's captive on several fronts:

- It was a sham.
- The parental guarantee of the deferred tax asset.
- The arrangement between the commonly controlled entities did not qualify as insurance for federal income tax purposes.

The majority decision pointed to the legitimate business purpose leading to RAC's creation of the captive, pointing out that the intent was to obtain coverage for the insureds that was otherwise unavailable, addressing gaps in coverage obtained through the commercial marketplace. Importantly, taxes were deemed to be a consideration but not a driver behind the creation of the captive. The payment methodology of netting premiums and losses was determined to be customary and merely a bookkeeping simplification. The captive's capitalisation, while less than that typically found in the commercial marketplace, was deemed to be sufficient due to the differences in business model between a captive and a commercial insurer.

In addition, the captive was appropriately regulated in a recognised domicile, it charged actuarially determined premiums, and it was adequately capitalised. For these reasons, the majority dismissed the IRS's sham argument.

Qualifying as insurance

The majority next looked at the judicial history of this issue, including pro-IRS decisions they reached in the 1980s and 1990s (which were subsequently overturned on appeal). These cases established a four criteria framework for determining whether an arrangement qualifies as insurance for federal income tax purposes. They are: (i) the arrangement must involve insurance risk; (ii) risks must be shifted; (iii) risks must be appropriately distributed among a sufficient number of insureds; and (iv) the arrangement must meet the commonly accepted notions of insurance.

The majority examined whether the arrangements met the commonly accepted notions of insurance. The fact that the captive was adequately capitalised, regulated by Bermuda, issued valid and binding insurance contracts, charged actuarially determined premiums, and actually paid claims, was deemed sufficient to constitute insurance in the commonly accepted sense.

In this case, the coverage insured by the captive (workers' compensation, automobile and general liability) were clearly insurance (rather than investment) risks, which the IRS conceded.

Risk shifting

With respect to risk shifting, the court reviewed the precedent holding that a parent company insuring with its wholly owned subsidiary is deemed not to shift the risk away from the parent (the reasoning for this is that a claims payment to the parent by the captive subsidiary does not result in a true change in the parent company's economic standing).

The court then analysed the case law regarding insurance in a brother/sister setting, including the outright rejection of the IRS's "economic family" theory (which stood for the proposition that any risk retained within a family of related entities was a non-deductible reserve rather than an insurance arrangement). In these prior cases, the Tax Court had not approved any insurance arrangement among brother/sister companies, but the US Court of Appeal for the Sixth Circuit did in two cases that were appealed from the Tax Court appeal.

The majority then determined that their analysis in the prior cases did not appropriately examine the impact of claims payments on the balance sheet and net worth of the insureds. Unlike the situation where a claims payment by a captive subsidiary to its parent company has no meaningful impact on the balance sheet or net worth of the parent company, claims payments by a captive to one of its sister companies does have a meaningful impact upon that insured's balance sheet and net worth. The majority then examined the parental guarantee of the captive's deferred tax asset.

In this case, since the parent was never called upon to make good on the guarantee, nor was the captive undercapitalised, the guarantee was determined not to affect risk shifting. Accordingly, the Tax Court determined that the premiums paid to RAC's captive by the other subsidiaries did in fact shift risks away from those other subsidiaries.

Risk distribution

The majority looked to the Sixth Circuit cases that determined that distributing risks among a sufficient number of brother/sister entities achieved risk distribution. The majority also relied on the fact that the brother/sister entities owned between 2600 and 3100 stores and operated between 7100 and 8027 vehicles during the years in question. This variety of risks was deemed to be a "sufficient number of statistically independent risks" giving rise to adequate risk distribution.

Lessons learned and unanswered questions

So, what did we learn from this case? Firstly, it is critically important that a captive be formed for non-tax reasons. While the Tax Court did not devote much of its opinion to this aspect, it was clearly an important factor in reaching its decision. Secondly, a captive needs to be adequately capitalised and it should be regulated in a recognised jurisdiction. Actuarially determined premiums and actual payment of claims are critically important. Insurance companies pay claims; so should a captive.

What did the decision not answer? Firstly, it did not answer what is "adequate capitalisation"? The majority determined the captive was adequately capitalised but did not provide much guidance as to how this conclusion was reached, other than pointing out that the capital exceeded both the statutory minimum as well as that suggested by the feasibility study. This was clearly a source of contention between the majority and those judges that dissented.

The majority and dissenters also disagreed about the impact of the parental guarantee. The dissent stated that majority improperly relied upon the fact that the parent was never called on to make good on the guarantee. It's unclear what the appropriate resolution of this issue is.

Perhaps most importantly, it is unclear whether the IRS is now moving away from the brother/sister safe harbor it issued in Revenue Ruling 2002-90. This ruling provided that risk distribution is deemed to exist in a situation where a captive insurance company insured 12 entities under common ownership and where no single insured accounted for more than 15 percent nor less than 5 percent of the total risks being insured. RAC's captive insured 15 of its sister companies, and it was fairly apparent that none of those accounted for more than 15 percent nor less than 5 percent of the total risks.

Three key takeaways

Perhaps these questions will be answered in a future opinion, assuming that the IRS appeals against this decision. In the meantime, it would be prudent for captive owners to ensure that:

- Their captives have more than sufficient capital to meet their obligations;
- Their entities are domiciled in jurisdictions that sufficiently regulate captives; and
- Dealings with their captive are beyond reproach.

This will not guarantee that the IRS will respect the arrangement as insurance, but it will certainly provide obstacles to their attack. CIT

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