Friends of the court

Recent cases have proven that it is critical that captives are organised in jurisdictions where there is an appropriate level of regulation, according to Alan Fine of Brown Smith Wallace

In January 2014, the US Tax Court handed down a pro-taxpayer case related to the federal income tax deductibility of insurance premiums paid to a commonly controlled captive insurance company. This case, Rent-A-Center v Commissioner, provided insight into several issues that have long been sources of contention between the Internal Revenue Service (IRS) and taxpayers.

A recent tax court memorandum case, Securitas Holdings v Commissioner, further supports the conclusions reached in the Rent-A-Center case, and expands options available to taxpayers when structuring their captive insurance programme. It also reinforces some of the basic principles that all captive owners would be wise to follow in their dealings with captives.

Securitas AB is the Swedish parent of Securitas Holdings (SHI), which owns a number of affiliated corporations in the US that provide security services, including uniformed security officers, alarm system installation and various cash handling services. During the years in question, SHI had no employees or vehicles and did not provide security services of its own. From 1999 to 2001, SHI acquired a number of additional security businesses. The acquired companies collectively employed approximately 123,000 people, bringing the total number of employees to more than 200,000 during 2003 and 2004.

In response to the dramatic rise in insurance costs in the early 2000s, Securitas implemented a captive insurance programme to control its risks and obtain more favourable insurance rates. The captive also enabled Securitas to centralise risks and for the subsidiaries to know in advance their costs of risk.

As part of this programme, SHI acquired Protectors Insurance of Vermont in 2000. Between 1996 and 2002, Protectors wrote no new or renewal business and its operations were confined to the runoff of previously written policies. Protectors maintained its own books and records, maintained a separate bank account for its operations, prepared financial statements and held annual board of directors meetings.

In June 2003, Protectors received permission from the Vermont Department of Insurance to lend all but $1 million of its capital to SHI. The

regulators then allowed Protectors to issue an insurance policy in 2004 without requiring SHI to contribute additional capital.

In 2002, Securitas formed a new captive reinsurance company, SGRL, in Ireland. At no point in 2003 or 2004 did any of the US operating subsidiaries own any interest in SGRL.

As with Protectors, SGRL maintained separate books and records, maintained a separate bank account for its operations, prepared financial statements, and held meetings of its board of directors. SGRL then reinsured the workers' compensation, automobile, employment practice, general liability and fidelity liability risks issued by Protectors as well as some of the policies insured in the commercial market.

During the years in question, the premiums were paid by two of the SHI subsidiaries on behalf of the other subsidiaries. Journal entries were used to record liabilities on the books and records of the insureds, as was the practice by Rent-A-Center. These premiums were reviewed by outside actuaries and determined to be reasonable.

Upon examination, the IRS disallowed portions of the federal income tax deductions for insurance premiums paid to the captive in 2003 and 2004.

Determining if an arrangement qualifies as insurance

In reaching its decision to uphold the deductibility of the premium payments, the court reviewed the framework utilised for determining whether an arrangement qualifies as insurance for federal income tax purposes.

Did the risk shift from insured to insurer?

The court reviewed the balance sheet and net worth analyses used in the context of brother-sister captive insurance arrangements to determine whether the insured had moved the risk of loss with respect to a covered claim to the insurer. The IRS argued that a guarantee from SHI to Protectors prevented the risk of loss from shifting to the insurer. The Tax Court, citing its opinion in Rent-A-Center, distinguished this case because the parental guarantee here did not involve an undercapitalised captive, nor was the underlying insurer insolvent.

The court further distinguished the current situation by focusing on the fact that the guarantee was provided only to provide the tax-exempt status of a related captive and, perhaps most importantly, no amount was paid out on the guarantee.

The court further focused on the fact that Protectors was adequately capitalised, and its net premium to surplus ratio was well below the industry standard. It also stressed that this determination was to be made after considering the impact of reinsurance.

The court also reviewed the system of allocating premiums and addressing the claims submitted to Protectors. It had no problem with the utilisation of accounting entries for addressing premium and claims obligations. The court cited the Rent-A-Center opinion: "It is unrealistic to expect members of a consolidated group to cut checks to each other and using journal entries to keep track of the flow of funds is commonplace."

This is particularly noteworthy given that the IRS frequently takes issues with such arrangements, and it eases the burden on taxpayers. It is still critical that the premiums be determined on an arms-length basis and confirmed with an outside actuary wherever possible.

Was there adequate risk distribution?

The court examined whether the arrangement met the requirement of risk distribution. In this case, in 2003 and 2004 one of the insureds accounted for 37 percent and 88 percent of the risks insured with Protectors. The IRS argued that this concentration of risk violated the concept of adequate risk distribution.

Historically, the examination of risk distribution has focused on the number of insureds, particularly within the brother-sister captive arrangements. Revenue Ruling 2002-90, for example, provided a safe harbour for those situations where there are 12 entities under common control being insured by a captive. In that case, as long as none of the insured accounts for more than 15 percent of the risk or less than 5 percent of the risk, the risks will be deemed to be sufficiently distributed. There are a number of cases that have utilised a similar framework, as well as IRS rulings that focus on the 15 percent upper standard.

The tax court rulings in Securitas and Rent-A-Center take a different focus, specifying that the concept of risk distribution is viewed from the insurer's perspective. The court focused on the significant number of employees (in excess of 123,000), offices, vehicles and services being insured, and that this constituted a large pool of "statistically independent risk exposures". This large number of independent risk exposures is not changed merely because "multiple companies merged into one".

The risks associated with those companies did not vanish once they all fell under the same umbrella. It is the pooling of exposures that brings about risk distribution—who owns the exposures is not crucial. Accordingly, the court found the arrangement to have sufficient risk distribution.

Did the captive arrangement constitute insurance?

The court then analysed whether the captive arrangement constituted insurance in the commonly accepted sense. Factors previously considered in this analysis include whether: (i) the insurer was organised, operated and regulated as an insurance company; (ii) the insurer was adequately capitalised; (iii) the insurance policies were valid and binding; (iv) the premiums were reasonable; and (v) the premiums were paid and the losses were satisfied.

The court found that both insurance companies were properly organised, operated and regulated. Critically important in this analysis was the fact that each company maintained its own books and records, prepared financial statements and held meetings of their respective boards of directors. They also found the companies to be adequately capitalised, the policies to be valid and binding, the premiums reasonable, and losses satisfied.

Tax Court upholds deductibility of premiums

The court upheld the deductibility of the premiums paid in this case. Securitas Holdings v Commissioner, read in conjunction with Rent-A-Center, offers clear support for examining the number of independent risks being insured rather than the number of entities (especially given that, in 2004, 88 percent of the risks were paid for by a single entity).

Still left unanswered are questions related to parental or other guarantees. Unexercised guarantees in Rent-A-Center and Securitas were found to not disturb the presence of risk shifting. It is unclear whether any exercise of a parental guarantee will automatically invalidate risk shifting, or if a partial exercise may leave risk shifting unaltered.

These cases demonstrate that courts will emphasise observing the common notions of insurance. For captive arrangements to be respected, it is critical that captives are organised in jurisdictions where there is an appropriate level of regulation.

Observing the corporate formalities of the captive is also important, including maintaining individual books and records, issuing financial statements and conducting board of director meetings. Although this won't prevent IRS scrutiny, it will significantly increase the captive's chances in court, should a case go that far. CIT

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