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Captive Insurance Litigation: Key 2014 Cases

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In 2014, the U.S. Tax Court issued two opinions with significant implications in the captive insurance world. On January 14, 2014, the court issued a reviewed decision in *Rent-A-Center, Inc. v. Commissioner*. On October 29, 2014, the court issued its opinion in Securitas Holdings, Inc. v. Commissioner. In both cases, the court held for the taxpayer.

The ultimate issue in both cases was whether the taxpayers could deduct premiums paid for workers compensation and other liability coverages to affiliated captive insurance companies. Captive insurance companies are companies related by ownership to the companies that are insured. In Rent-A-Center, subsidiaries of the taxpayer paid premiums for insurance coverage to Legacy, a related Bermudian insurance subsidiary of the taxpayer. In Securitas, the U.S. Securitas group paid premiums for insurance coverage to Protectors Insurance Co. of Vermont (owned by the taxpayer), which reinsured these coverages with an Irish reinsurer, Securitas Group Reinsurance Limited (owned by Securitas AB, the taxpayer's parent).

Historically, the Internal Revenue Service (IRS) has been skeptical about captive insurance arrangements, reflecting a prejudice that related-party transactions should generally not enjoy the benefits of insurance reserve accounting for federal income tax purposes. The IRS attack on captives was initiated by a 1977 Revenue Ruling, which was followed by an initial wave of significant litigation. In a second wave of litigation in the 1990s, the courts established the following four criteria to determine whether a captive arrangement constitutes insurance for federal income tax purposes:

- The arrangement must involve insurable risks.
- The arrangement must shift the risk of loss to the insurer.
- The insurer must distribute risks among policyholders.
- The arrangement must be insurance in the commonly accepted sense.

Rent-A-Center and Securitas are the leading cases in a third wave of captive litigation focusing on particular elements of the insurance criteria. The Tax Court in these cases addressed two significant issues: whether the presence of a guarantee of the captive insurer by its parent per se vitiates risk transfer, and whether a high concentration of risks in a single insured violates the risk distribution criteria.

The IRS position in Rent-A-Center and Securitas was that a parental guarantee per se prevented risk shifting from brother-sister subsidiaries to the captive insurer. In prior cases, the IRS had successfully challenged captive arrangements where a parent guaranteed the performance of a captive subsidiary. In Rent-A-Center, the court found that the guarantee, which was issued for accounting purposes and to meet Bermuda's solvency requirements, did not prevent the shifting of risk. Similarly, in Securitas, the non-insured parent taxpayer guaranteed the liabilities of the intermediate insurance company, Protectors. The court stated that "the existence of a parental guaranty by itself is not enough to justify disregarding a captive insurance arrangement." The court then analyzed the facts and found that risks were shifted to the captive. Thus, Rent-A-Center and Securitas establish that parental guarantees do not per se vitiate risk shifting in captive arrangements; instead, the issue requires a facts and circumstances analysis.

With regard to risk distribution, the court ruled that it is the number of risks, rather than the number of insureds, that determines whether risk is adequately distributed. In the context of brother/sister captive insurance arrangements, where the operating subsidiaries of an affiliated group insure risks with a sister captive insurance company, the IRS has found no risk distribution where only a few related corporations insure a significant number of risks with the captive. In both Rent-A-Center and Securitas, the IRS contended that such arrangements did not constitute insurance because they did not distribute risk among a sufficient number of policyholders. For example, inSecuritas, the government argued that the arrangement did not adequately distribute risk among policyholders because too much of the risk (more than 75 percent in one year) was concentrated in one of the policyholders.

The court in Rent-A-Center stated that "[i]n analyzing risk distribution, we look at the actions of the insurer because it is the insurer's, not the insured's, risk that is reduced by risk distribution." Because Legacy insured thousands of statistically independent risks, the court found that there was adequate risk distribution. The court similarly reasoned in Securitas:

> Risk distribution is viewed from the insurer's perspective. As a result of the large number of employees, offices, vehicles, and services provided by the U.S. and non-U.S. operating subsidiaries, [the Irish reinsurer] was exposed to a large pool of statistically independent risk exposures. This does not change merely because multiple companies merged into one. The risks associated with those companies did not vanish once they all fell under the same umbrella. As the SHI Group's expert, Dr. Neil Doherty, explained in his expert report: "It is the pooling of exposures that brings about the risk distribution—who owns the exposures is not crucial." We agree and find that by insuring the various risks of U.S. and non-U.S. subsidiaries, the captive arrangement achieved risk distribution.

These Tax Court decisions unmistakably adopt the position that risk distribution depends on the presence of a sufficient number of individual risks and not on the number of insureds.