Industry Update

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In January 2014 the United States 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.

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 decisions of the 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 insurance company could provide many benefits, including reducing costs and improving its overall risk management. In late 2002, RAC incorporated and capitalized its captive insurance company with capital in excess of that recommended in the feasibility study performed by Aon. As part of its due diligence, RAC requested a fee quote from Discover Re for the coverages to be insured in the captive (additional coverage for workers' compensation, automobile and general liability claims below that insured by Discover Re). Discover Re responded that it would not insure the coverages 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.

The IRS attacked RAC's captive on several fronts; first, that it was a sham; second, the parental guarantee of the deferred tax asset in order to meet minimum capital requirements was part of the sham; and third, that 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 which 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. In this case, the coverages insured by the captive (workers' compensation, automobile and general liability) were clearly insurance (rather than investment) risks, which the IRS conceded. The majority also determined that the parental guarantee of the captive's deferred tax asset did not render the arrangement a sham, at least in part because the parent was never called upon for the guarantee (a point vigorously contested by the dissent).

The majority, analyzing the impact of claims payments on the insured brother/sister corporation's balance sheet and net worth, next concluded that the arrangement produced the requisite risk shifting, notwithstanding the parental guarantee of the deferred tax asset. As to risk distribution, the majority determined that distributing risks amongst a sufficient number of brother/sister entities achieved risk distribution, in part relying upon the fact that the brother/sister entities owned between 2,600 and 3,100 stores and operated between 7,100 and 8,027 vehicles during the years in question.

Finally, the Court concluded that the arrangements met the commonly accepted notions of insurance, since the captive was adequately capitalized, was regulated by Bermuda, issued valid and binding insurance contracts, charged actuarially determined premiums and actually paid claims.

So, what did we learn from this case? The most important lessons are the importance of having a non-tax business purpose for forming the captive and treating the captive like a true insurance company. Captives need to be adequately capitalized and should be regulated in a recognized jurisdiction, like Delaware or Utah (among others). Actuarially determined premiums and actual payment of claims are critically important. Payment arrangements should mirror those found in the commercial marketplace, where premiums are billed and collected throughout the year rather than immediately prior to year-end. Finally, like commercial insurance companies, captives should pay claims.

The decision left open what is deemed to be "adequate capitalization."

Perhaps these questions will be answered in a future opinion, assuming that the IRS appeals 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, that their captive is domiciled in a jurisdiction that sufficiently regulates captives, and to make sure that dealings with their captives are all beyond reproach. This will not guarantee that the IRS will respect the arrangement as insurance, but will certainly provide obstacles to any potential attack.

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