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Rent-A-Center's Captive Passes Muster in U.S. Tax Court; IRS Not Likely to Appeal

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The U.S. Tax Court Jan. 14 issued its ruling in *Rent-A-Center Inc. v. Commissioner*, 142 T.C. No. 1, 2014 BL 9532 (1/14/14), holding that payments by Rent-A-Center's (RAC) wholly owned subsidiaries to RAC's wholly owned Bermuda captive insurance company, Legacy, were deductible as legitimate insurance expenses.

In the split decision, the majority found that Legacy was a legitimate, bona fide insurance company created for ''a myriad of significant and legitimate nontax considerations.''

While RAC's captive structure is far from perfect, the IRS will most likely forgo an appeal because of what a loss or even a win at the circuit level might mean.

The captive insurance world of captive owners and service providers has been waiting three years for this decision, and now that the decision is in, the next question is whether the Internal Revenue Service (IRS) will appeal the decision to the Fifth Circuit. While RAC's captive structure is far from perfect—there may be issues with parental guarantees and some creative accounting positions (all thoroughly covered in the dissenting opinion)—the IRS will most likely forgo an appeal because of what a loss or even a win at the circuit level might mean.

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The *RAC* decision affirms the holding in *Humana Inc. v. Commissioner*, 881 F.2d 247 (6th Cir. 1989), in which the U.S. Court of Appeals for the Sixth Circuit held that insurance premium payments by brother-sister subsidiaries to a captive insurance company owned by the same common parent were tax deductible. In *Humana*, the court held premium payments attributable to the risk exposures of the captive's brother-sister entities were deductible based on a ''balance sheet'' approach under which risk shifting depends on the effect of the arrangement on the policyholder's net assets.

Given that the IRS previously lost at the circuit level on the brother-sister issue in *Humana*, the IRS could well do more harm than good for itself on appeal, even if the *RAC* decision is overturned.

Obviously, if the IRS loses on appeal, there will be two circuit court decisions holding in favor of brother-sister captive programs. But even if the IRS wins, opposing opinions in the Fifth and Sixth circuits may open the window for a U.S. Supreme Court appeal by the taxpayer. While the IRS may welcome an opportunity to overturn the *Humana* decision with a favorable U.S. Supreme Court ruling, the IRS is unlikely to pick a case where the facts and circumstances aren't stacked in their favor. Instead, the IRS will likely wait for a better opportunity to take these issues before the highest court of the land.

Growing Use of Captives

All companies are subject to risks for which they can't be insured either because the policies are prohibitively expensive or because commercial insurance companies don't offer such policies, e.g. the difficulty in acquiring liability insurance during the 1980s. In other cases, some enterprises are using captives for additional financial protection against supply chain interruptions such as what happened after the March 2011 tsunami roiled Japan.

In general, businesses of all kinds are more cognizant about risk and concerned about the commercial insur-

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ance market in light of catastrophic events over the past decade such as the 9/11 terrorist attacks, Hurricane Katrina and the financial meltdown of 2007. As companies become more knowledgeable there is a growing appreciation of the need to insure against non-traditional risks such as pollution, product tampering and terrorism.

Companies can plan financially for these risks by self-insuring, putting aside money for future use in the event a risk becomes an actuality. However, under standard accounting and tax rules, funds channeled into these reserve accounts cannot be deducted like ordinary insurance premium payments. In other words, companies that self-insure must use after-tax dollars.

A tax-efficient alternative can be made possible with a captive insurance company. These ''captives'' are insurance companies formed to insure against risks to which their parent groups are exposed. They came into modern use in the 1950s through a concept developed by Frederic Reiss in his dealings with his customer, the Youngstown Sheet & Tube Co. The company owned mining operations whose output was solely for the company's use, and the company referred to these mines as ''captive'' mines. Reiss applied that concept when he helped the company incorporate its own insurance subsidiaries because the insurance companies wrote policies solely for the captive mines.

Insurance in its modern form dates back to England in the 17th century, and to this day the pooling of premiums remains an efficient means to protect against risk for many situations. It isn't always cost effective, however, especially for enterprises that rarely file claims. In addition, traditional insurance excludes coverage under an assortment of conditions and doesn't really lend itself to customizing policies should a company have unique needs. Most crucial for many, there is a total loss of control over risk capital when purchasing traditional commercial insurance.

Most experts trace the roots of captives back to early 16th century England, where ship owners formed a kind of co-op agreement to share and transfer costs posed by the special risks associated with their fleets. Then in the 19th century, some textile manufacturers in New England established a mutual in response to high fire insurance rates, which eventually became the Factory Mutual System.

Although a mutual is similar to a captive because both are owned by their policyholders, there are distinct differences. In a mutual, policyholders just pay the premiums and don't invest any of their personal assets, plus the insureds don't have any ownership control. Captive insureds are owners with invested assets in the company.

These early arrangements in what amounts to self-insurance laid the framework upon which the captive industry as we know it today would develop.

Reiss established the first modern captive after attending a party in London during the early 1960s where he met an attorney from Bermuda. The lawyer believed Reiss's idea of a captive insurance company could be possible in Bermuda. Within a few years, Reiss had set up several captives in Bermuda—the first country to formalize the captive industry through laws designed to standardize licensing and oversight policies.

The health care industry provided an important boost for the captive model in the 1970s when health care facilities found it increasingly difficult to get reimbursed under Medicare and by other third-party participants. While health institutions historically shied away from retaining risk and self-insuring, preferring to pay a set premium that could be written off as an expense, as premiums increased and certain coverages became unavailable, self-insurance became more of a necessity than just another option. Soon more and more health care enterprises accepted self-insurance as an acceptable method of financing both professional and general liability for Medicare cost reporting purposes.

In the middle of the decade, Medicare reimbursement policies changed, which gave health care institutions more flexibility in structuring their programs, making the entry into captives possible, thereby formalizing the pre-captive self-insurance model. Specifically, the policy changes enabled them to pool risk beyond the entity's professional and general liability exposure. That meant pooling could extend to other institutional providers and physicians. It also meant risks such as workers' compensation insurance could be included in the program.

In 1976, the crisis of insurance availability led the Harvard Medical Institutions to form a ''captive'' medical professional liability insurer, CRICO, an offshore insurance company operating and domiciled in the Cayman Islands. CRICO pooled the risk of its physicians and other providers with the institution along with a single limit of liability. That format became the widely used model for many other tax-exempt health care enterprises.

There are currently more than 6,000 captive insurance companies with 30-plus domestic jurisdictions vying for more than $9 billion in annual premiums.

Reiss had to set up the first captive offshore because U.S. law didn't permit such a company to be formed in the U.S. at the time. While Bermuda is still the leading domicile for captives, many U.S. states now permit captives. In 1972, Colorado became the first state to allow captives. In the 1980s, Tennessee, Vermont and Hawaii threw their hats into the ring, followed by Delaware, the District of Columbia, Missouri, Montana and South Carolina.

There are currently more than 6,000 captive insurance companies with 30-plus domestic jurisdictions vying for more than $9 billion in annual premiums. Although it is a global industry, with around 100 domiciles available around the world, the majority of captives are domiciled in the western hemisphere and nearly 90 percent of Fortune 500 companies have one or more captives.

The captive insurance industry has exploded in the last two to three decades, with thousands of captives formed both internationally and domestically. As a result, the captive market has grown more appealing as it has evolved and proved itself able to offer consistently lower cost, more expansive coverage and better cash flow. Today captives have become an increasingly popular risk financing structure for both tax-exempt and for-profit companies and institutions.

IRS Attention

Because of the obvious and substantial tax benefits available to owners of captive insurance companies, the IRS monitors both the owners and service providers very closely. At the first sign of any perceived abuse, the IRS is likely to begin an investigation.

In the first few Tax Court cases, the IRS was successful in challenging captive programs because they still resembled and worked too much like pure self-insurance programs—where a deduction is clearly not appropriate. But as the programs became more sophisticated, learning from the mistakes of others, the IRS began to lose cases. After the rulings in *AMERCO Inc. v. Commissioner*, 979 F.2d 162 (9th Cir. 1992), *Sears, Roebuck & Co. v. Commissioner*, 972 F.2d 858 (7th Cir. 1992), and *Harper Grp. v. Commissioner*, 979 F.2d 1341 (9th Cir. 1992), the IRS decided to abandon its original primary legal theory against captives, the economic family doctrine, which posited that there cannot exist insurance between related parties. Citing *Malone & Hyde Inc. v. Commissioner*, 62 F.3d 835 (6th Cir. 1995), the IRS stated that its challenges to the deductibility of premiums paid to captive insurance companies would continue although now based on the particular facts and circumstances of each case.

An overall facts and circumstances approach is often viewed as a better barometer for purposes of determining whether a captive insurance program should be respected for federal tax purposes. Two requirements that must always be present in order for a financial arrangement to be considered ''insurance'' are risk shifting and risk distribution. The fundamental query then in captive insurance cases is whether payments to the captive insurer should be classified as ''insurance premiums'' and whether risk shifting (also known as ''risk transfer'') and risk distribution are present.

In order to determine whether risk shifting is present, one looks at whether some feature of the captive insurance arrangement negates risk shifting. Under the balance sheet theory articulated in *Humana* and refined in *Kidde Indus. v. United States*, 40 Fed. Cl. 42 (1997), risk shifting is negated in a situation where (in absence of third-party risk assumed by the captive) a wholly owned captive insures its parent company.

That is, from the perspective of an outside stakeholder of the parent (a creditor or stockholder), the assets of the parent wouldn't be insulated from the effect of third-party claims asserted successfully against the parent and paid by its wholly owned captive insurance subsidiary: To the extent that the captive insurance subsidiary incurs gains or losses because of such claims, the parent's assets are presumed to reflect an identical gain or loss in value because the stock of the captive is an asset of the parent.

However, in a captive insurance arrangement that involves only brother-sister related-party risk, the balance sheet theory has led to the conclusion that risk is shifted from the policyholders to the captive, under the *Moline Props. v. Commissioner*, 319 U.S. 436 (1943), doctrine. The reason for this (according to the balance sheet theory) is that a brother-sister policyholder that has no ownership interest in its sibling capital has no stake in the captive's underwriting results. In contrast, a captive's underwriting of its parent's risk doesn't result in risk shifting because the parent's assets include its stock in the captive insurance subsidiary. For every dollar of insurance proceeds that the parent receives from the captive, the parent's gain in net worth will be offset by a decrease in the value of its stock in the captive.

As discussed in *Humana*, the balance sheet theory was applied from the perspective of a creditor looking at the policyholder's assets: ''If we look solely to the insured's assets (*i.e.*, those of the various affiliates of Humana Inc.) and consider only the effect of a claim on those assets, it is clear that the risk of loss has shifted from the various affiliates to health care indemnity.''

The *Humana* court adopted the Ninth Circuit's analysis in *Clougherty Packing Co. v. Commissioner*, 84 T.C. 948 (1985), which stated:

> In reaching our holding, we do not disturb the legal status of the various corporate entities involved, either by treating them as a single unit or otherwise. Rather, we examine the economic consequences of the captive insurance arrangement to the ''insured'' party to see if that party has, in fact, shifted the risk. In doing so, we look only to the insured's assets, i.e., those of Clougherty. Viewing only Clougherty's assets and considering only the effect of a claim on those assets, it is clear that the risk of loss has not been shifted from Clougherty.

Thus, the balance sheet theory tests risk shifting solely on the basis of whether the policyholder affiliated to the captive would ultimately incur a loss in economic value if a claimant were successful against the captive. By this test, risk shifting could occur for any related-party policyholder that isn't in the vertical chain of ownership of the captive. The separate legal status of the policyholders is respected.

The balance sheet theory proceeds without regard to how income tax law may aggregate the income and tax attributes of legally separate persons for other income tax purposes.

The legal construct has controlling effect for the federal tax purpose of defining risk shifting in a captive insurance context. The legal analysis takes priority for characterizing the insurance transaction, and the federal tax treatment should follow from that legal analysis.

Because the balance sheet theory relies on the separate legal status of the subject insured entity, and the insulation of that entity's assets from the loss incurred by the captive, in order to determine risk shifting, the balance sheet theory proceeds without regard to how income tax law may aggregate the income and tax attributes of legally separate persons for other income tax purposes.

For example, whether or not the parent and captive insurance subsidiary file a consolidated tax return, where the parent is a partnership that owns 100 percent of a captive insurance company that insures only the parent's risk, or where an individual is the owner of an insurance company that insures only such person's risks, no risk shifting might be deemed to have taken place. In contrast, where a father owns the insured and his adult child owns the captive, application of the balance sheet theory would urge that risk shifting has taken place and that the captive is unrelated to the insured because a creditor of the father generally wouldn't be able to assert successfully (absent fraud) a claim that assets of the father include the assets of the child.

In *Kidde Industries*, the Court of Federal Claims applied the balance sheet theory to mean that where a common parent owns a captive insurer and operating subsidiaries and the captive insures both operating divisions of the parent and the brother-sister subsidiaries, then the insured risks of the brother-sister operating subsidiaries are to be deemed related-party risk in the captive's risk pool, with the result that risks of the parent (including the parent's operating divisions) are neither shifted nor distributed by being in the captive's risk pool. The premise behind the court's reasoning is that the ''relatedness'' of related-party risk arises from common ownership of the insurer and the insured.

By implication, where there is no common parent (whether corporate or individual) of the insurer and the insured, the insurer's risk pool necessarily consists of unrelated risk. By contrast, if one were to apply attribution rules usual in an income tax setting to the analysis of risk shifting, and risk distribution, then brother-sister subsidiary risk would be treated the same as parent risk vis-a-vis the captive.

Risk distribution incorporates the statistical phenomenon known as the Law of Large Numbers. In *AMERCO*, the Tax Court stated, ''The concept of risk-distributing emphasizes the pooling aspect of insurance: that it is the nature of an insurance contract to be part of a larger collection of coverages, combined to distribute risks between insureds.'' In *Commissioner v. Treganowan*, 183 F.2d 288 (2d Cir. 1950), the Second Circuit Court of Appeals explained that by ''diffusing the risks through a mass of separate risk-shifting contracts, the insurer casts his lot with the law of averages. The process of risk-distribution, therefore, is the very essence of insurance.''

Distributing risk allows the insurer to reduce the possibility that a single costly claim will exceed the amount taken in as premiums and set aside for the payment of such a claim. ''By assuming numerous relatively small, independent risks that occur over time, the insurer smoothes out losses to match more closely its receipt of premiums,'' the IRS has said in many rulings, citing *Clougherty Packing*. Risk distribution necessarily entails a pooling of premiums, so that a potential insured isn't in significant part paying for its own risks. The question of how many policyholders are needed to create risk distribution is an issue that has been debated in the courts for some years.

In the Tax Court, the two sides of the debate were drawn when this issue divided two concurring opinions in *Clougherty Packing*. In that case, Judge Lapsley Hamblen's concurring opinion stated:

> Risk-distribution may be described as ''. . . a method of dispelling the danger of a potential loss by spreading its cost throughout a group. By diffusing the risks through a mass of separate risk-shifting contracts, the insurer casts his lot with the law of averages.'' Clearly, there is no risk-distribution here because there is only one insured and, consequently, there can be no spreading of the exposure.

Taking the other side, Judge Julian Jacobs's concurring opinion stated, ''Nor do I subscribe to the position that, in every case in which the insured's policy is the only policy issued by the insurance company, the lack of risk-distribution, standing alone, is a sufficient ground for denying a deduction for the premium paid.''

In 2002, the IRS issued Rev. Rul. 2002-90, which stated its position on the subject: 12. According to the IRS, an insurance arrangement between a captive and 12 operating subsidiaries would be respected and would constitute insurance for federal income tax purposes. According to the IRS, risk-distribution was found to exist because a loss by one insured was substantially borne by the premiums paid by the others.

Rev. Rul. 2002-90 doesn't literally preclude the conclusion that risk distribution can exist only where a captive insures 12 or more policyholders. In *Gulf Oil Corp. v. Commissioner*, 89 T.C. 1010 (1987), the Tax Court majority opinion stated, '' 'unrelated' risks need not be those of unrelated parties; a single insured can have sufficient unrelated risks to achieve adequate risk-distribution.'' But even if there is merit to the notion that a captive must pool risk of more than one insured, the minimum number of insureds, theoretically at least, should be not more than two, as long as both insureds pool risk to an extent that significantly spreads the risk of loss among them.

Rev. Rul. 2002-90 stated IRS's position: 12. According to the IRS, an insurance arrangement between a captive and 12 operating subsidiaries would be respected and would constitute insurance for federal income tax purposes.

At the very least, Rev. Rul. 2002-90 should be compared to *Humana* where the Sixth Circuit held that insuring the risks of seven brother-sister companies was sufficient risk distribution to constitute insurance.

'Rent-A-Center' Ruling

RAC is an American public furniture and electronics rent-to-own company based in Plano, Texas. The company was incorporated in 1986 and as of 2011 operated approximately 3,074 company-owned stores in the United States, Canada, Puerto Rico and Mexico, accounting for 35 percent of the rent-to-own market in the U.S. based on store count. RAC operates retail locations in all 50 states and has approximately 3,000 stores, 19,000 employees and 8,000 vehicles.

Prior to the formation of Legacy, Travelers Insurance Co. provided RAC's workers' compensation, automobile and general liability coverage through bundled policies. In 2001, after receiving an invoice from Travelers in the amount of $3 million for ''claim handling fees,'' RAC began looking elsewhere for insurance. RAC became dissatisfied with the cost and inefficiency associated with its bundled policies and engaged Aon Risk Consultants Inc. to analyze risk management prac-

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tices and to broker workers' compensation, automobile and general liability insurance.

In 2002, after analyzing petitioner's insurance program, Aon suggested that RAC form a wholly owned insurance company, a captive, due to its financial and nonfinancial benefits, including the reduction of costs, improved efficiencies, obtaining otherwise unavailable coverage, accountability and transparency. Subsequently, AON conducted a feasibility study based on the petitioner's loss experience and KPMG reviewed applicable tax considerations and prepared financial projections.

RAC incorporated Legacy Dec. 11, 2002, and capitalized it with approximately $10 million. Then, on its subsidiaries' behalf, RAC negotiated insurance policies with Legacy and other third-party insurers. Legacy issued workers' compensation, automobile and general liability policies covering RAC's subsidiaries. The annual premium paid to Legacy was determined using Aon's loss forecasts. Although RAC paid the annual premium, RAC sought reimbursement from each of the 15 subsidiaries in the form of a monthly fee. The allocation was based on each subsidiary's number of stores, vehicles and payroll. During the years in question (2002-2007), RAC's captive earned net underwriting income of $28.8 million.

In 2008, the IRS began looking into RAC's captive insurance program. After concessions, the remaining issue was whether payments from RAC to Legacy were deductible as insurance premium expenses.

According to the IRS, Legacy ''was a sham entity created primarily to generate Federal income tax savings.'' The IRS argued that the amounts RAC paid to Legacy on behalf of its other subsidiaries weren't deductible as insurance premiums because:

- RAC was the listed policyholder and paid the premiums on behalf of its subsidiaries;
- RAC guaranteed the liquidity of Legacy's deferred tax assets;
- Legacy invested in nondividend-paying treasury stock of RAC; and
- risks were concentrated in a relatively small number of sibling corporations.

The court disagreed. The court stated that the relevant inquiry was whether Legacy was a bona fide insurance company. In holding that Legacy was in fact a bona fide insurance company, the court determined that Legacy met the necessary criteria—risk shifting, risk distribution, insurance risk and commonly accepted notions of insurance. The court went on to enumerate the various factors supporting its conclusion that Legacy was a bona fide insurance company.

Legacy Was Created for Significant And Legitimate Nontax Reasons

The court said:

> AON proposed that petitioner form a captive, and petitioner determined that a captive would allow it to reduce its insurance costs, obtain otherwise unavailable insurance coverage, formalize and more efficiently manage its insurance program, and provide accountability and transparency relating to insurance costs. . . . Federal income tax consequences were considered, but the formation of Legacy was not a tax-driven transaction . . . . To the contrary, in forming Legacy, petitioner made a business decision premised on a myriad of significant and legitimate nontax considerations.

There Was No Impermissible Circular Flow of Funds

The court said:

> . . . [R]espondent cites a purported ''circular flow of funds'' through Legacy, RAC, and RAC's subsidiaries. Respondent's expert, however, readily acknowledged that he found no evidence of a circular flow of funds, nor have we. . . . [P]etitioner established that there was nothing unusual about the manner in which premiums and claims were paid.

The Premium-to-Surplus Ratios Don't Indicate That Legacy Was a Sham

The court said:

> Commercial insurance companies have lower premium-to-surplus ratios because they face competition and, as a result, typically price their premiums to have significant underwriting losses. They compensate for underwriting losses by retaining sufficient assets (i.e., more assets per dollar of premium resulting in lower premium-to-surplus ratios) to earn ample amounts of investment income. Captives in Bermuda, however, have fewer assets per dollar of premium (i.e., higher premium-to-surplus ratios) but generate significant underwriting profits because their premiums reflect the full dollar value, rather than the present value, of expected losses.

Legacy Was a Bona Fide Insurance Company

The court said:

> . . . [P]etitioner faced actual and insurable risk. Comparable coverage with other insurance companies would have been more expensive, and some insurance companies . . . would not underwrite the coverage provided by Legacy. In addition, RAC established Legacy for legitimate business reasons . . . . Furthermore, Legacy entered into bona fide arm's-length contracts with petitioner; charged actuarially determined premiums; was subject to the BMA's regulatory control; met Bermuda's minimum statutory requirements; paid claims from its separately maintained account; and . . . as respondent's expert readily admitted, was adequately capitalized. . . . Moreover, the validity of claims Legacy paid was established by SRS, an independent third-party administrator, which also determined the validity of claims pursuant to the Discover Re policies . . . . Finally, RAC's subsidiaries did not own stock in, or contribute capital to, Legacy.

Authority for tax positions is often gleaned from a careful reading of the statutes, the case law and the various IRS rulings and pronouncements. Taxpayers and their advisers should never lose sight of the fact that some of the positions taken by the IRS in its rulings and pronouncements are more a matter of opinion than law. And until those opinions are tested in a court of law, a difference of opinion can genuinely exist between taxpayers and the IRS. *Rent-A-Center Inc. v. Commissioner* is an example of one such controversy, ultimately settled in favor of the taxpayer.

The *RAC* decision is being received by the captive community as another confirmation that captive insurance arrangements, when properly considered and carried out for legitimate non-tax purposes, will withstand challenges from the IRS. It is doubtful that the IRS will appeal the *RAC* decision, but we can be certain that the IRS will continue to scrutinize captive insurance arrangements very closely.