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Tax Court: Captive does not qualify as insurance company, premiums paid not deductible

The U.S. Tax Court this week found that a corporation was not an insurance company and invalided the company's election under section 831(b). As a result, premiums received must be recognized as income and premiums paid were not deductible. Reasonable cause existed to prevent the imposition of penalties, however.

The case is *Syzygy Insurance Co. v. Commissioner*, T.C. Memo. 2019-34 (April 10, 2019). Read the **memorandum opinion*** [PDF 52 pages]

*A Tax Court memorandum opinion is an opinion issued by the Tax Court in a case with respect to which the law is settled or factually driven (i.e., in a case which does not involve a novel legal issue). A Tax Court memorandum opinion may be cited as precedent.

Background

The taxpayer was incorporated in 2008 in Delaware and regulated as an insurance company.

The taxpayer was owned 50% by two limited liability companies (LLCs), each of which were wholly owned by a separate individual. These two individuals also each generally had a 50% direct or indirect interest in various related companies comprising a business that was an above- and below-ground steel tank manufacturer. As a result of S corporation elections and other arrangements, the income of these related companies was generally reflected on the tax returns of the two individuals (either as a result of direct or indirect ownership in an entity or as the result of being a grantor in a trust with a direct or indirect ownership interest). For the years at issue, the taxpayer made an election under section 831(b) and reported no taxable income.

In 2008, one of the individuals considered forming a captive insurance company to manage the risks for the tank manufacturer. That individual consulted with a company based in Irvine, California, that ran a captive insurance program and provided management services for captive insurance companies.

In October 2008, the California company initially indicated that at least $600,000 of premiums were needed to make the captive feasible. Later, the California company's chief underwriter determined as a

"will ass guess" [sic] that premiums would be between $500,000 and $800,000. Based on these recommendations, the tank manufacturer proceeded with the captive, which was formed in December 2008.

For 2009-2011 (the years at issue), the tank manufacturer's risk management program generally worked as follows.

- Two fronting companies wrote various policies for the tank manufacturer's risks (e.g., administrative actions, bankruptcy preference, cyber liability, deductible reimbursement, legal expense, intellectual property defense, intellectual property enforcement, and property (difference in conditions)).[1]

- After a fronting fee, the fronting companies generally ceded all of the remaining premiums to the taxpayer in two layers.

    - Layer 1 claims consisted of the first $250,000 of any of the manufacturer's claims that were reinsured by the taxpayer.

    - Layer 2 claims were the manufacturer's claims between $250,000 and $1 million that were reinsured by the taxpayer on a quota share percentage. The quota share was the ratio of: (1) the net premium that the manufacturer paid to that portfolio to (2) the aggregate net premiums the portfolio received for the insurance period.

Additionally, the taxpayer provided layer 2 reinsurance for a diverse array of approximately 857 policies issued to unrelated companies in the fronting carriers' pools. The taxpayer reinsured approximately 40 to 50 unrelated companies per pool.

Under the terms of the policies, there was no provision for pro rata refunds if the policies were canceled during the policy terms. Additionally, claims on the policies could be made only within seven days after the policy period closed, and there was no option to purchase an extended claims reporting period.

During the years in issue, neither the taxpayer nor the fronting carriers timely issued a policy to the manufacturer. The policies for 2009 and 2010 were not issued until after the policy years ended.

Premiums paid by the manufacturer to the fronting companies were $510,000, $545,000, and $318,000 for 2009, 2010, and 2011, respectively. The premiums were set by the chief underwriter (who was not an actuary) of the California company. The underwriting report relied on information provided by the manufacturer and did not detail the rating model, calculations, or any other detailed analysis describing how premiums were determined. Instead, the report provided only general information about projected losses, previous claims, and information about the manufacturer's other insurance. There was nothing in the underwriting report to suggest that comparable premiums information was considered.

During the years at issue, the manufacturer did not file any claims under their captive program policies. It did, however, file multiple claims under their commercial insurance policies and incurred deductibles. The manufacturer did not have a claims management system in place for the captive program, even though there were other claims processes in place for their commercial policies.

At all relevant times, the taxpayer met Delaware's minimum capitalization requirements. The taxpayer was initially capitalized with a $250,000 irrevocable letter of credit.

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[1] Two entities acted as the fronting company, one for 2009-2010, and another for 2011.

- By the end of 2009, the taxpayer's assets totaled $1,218,713 and consisted of: (1) the $250,000 letter of credit; (2) $183,740 of cash and cash equivalents; and (3) $784,973 of unceded premiums.

- By the end of 2010, the taxpayer's assets increased to $1,460,931 and consisted of: (1) the $250,000 letter of credit; (2) $349,500 of cash and cash equivalents; (3) $561,431 of unceded premiums; and (4) two life insurance policies worth $300,000.

- By the end of 2011, the taxpayer's listed assets decreased to $1,136,389 and consisted of: (1) $45,395 of cash and cash equivalents; (2) $158,374 of unceded premiums; (3) a $250,000 certificate of deposit; (4) mutual funds holding bonds worth $79,436; and (5) two life insurance policies worth $603,184.

The taxpayer did not own the life insurance policies noted above. Instead, the policies were owned by two trusts related to the two individual owners of the manufacturer. The taxpayer was not a beneficiary of either policy. The policies' respective beneficiaries were the trusts.

In June 2010, the taxpayer entered into separate split-dollar life insurance agreements with the respective trusts regarding the life insurance policies. Under the terms of the agreements, the taxpayer agreed to pay premiums for policies insuring the two owners of the tank manufacturer. The taxpayer's only rights to the policies' proceeds were defined in the split-dollar agreements. Upon the death of an insured, the taxpayer was entitled to the greater of: (1) the premiums that it had paid with respect to the policy; or (2) the policy's cash value. If the policy was terminated during the life of an insured, the taxpayer was entitled to the total amount payable under the policy.

The taxpayer was prohibited from accessing the cash values of the policies, borrowing against the policies, surrendering or canceling the policies, or taking any other action with the respect to the policies. The taxpayer and the trusts were allowed to assign their rights.

The agreements could be terminated only through the mutual consent of the taxpayer, the respective insured, and the respective trust. Within 60 days of termination, the owner had the option to obtain a release of the taxpayer's interest in the policy. To obtain the release, the policy owner was required to pay the taxpayer the greater of: (1) the premiums that it paid with respect to the policy; or (2) the policy's cash value. If the policy owner did not obtain a release, ownership of the policy reverted to the taxpayer.

The taxpayer paid $300,000 of premiums for the life insurance policies in both 2010 and 2011. Neither the policies nor the agreements were terminated during the years in issue.

In 2011, the taxpayer exited the captive insurance program of the California company. The change was, in part, related to the more than $200,000 decrease in premiums in the company's program from 2010 to 2011.

The IRS examined the returns for the taxpayer as well as the other individual returns affected by the premium payments to the taxpayer.

- With respect to the taxpayer, the IRS determined that the taxpayer did not engage in insurance transactions and was not an insurance company. Accordingly, the IRS determined that the section 831(b) election was invalid and that the premiums that the taxpayer received were taxable income. The IRS also imposed accuracy-related penalties.

- With respect to the individual petitioners, the IRS determined that: (1) the arrangement was invalid for lack of economic substance; (2) the premium payments were not payments for insurance; and (3) the amounts deducted were not ordinary and necessary business expenses. Accordingly, the IRS disallowed the deductions and imposed accuracy-related penalties.

Tax Court's opinion

The Tax Court ultimately agreed with the IRS and sustained the IRS's assessment of tax.

The Tax Court considered the four criteria of insurance discussed in case law—i.e., risk shifting, risk distribution, insurance in the commonly accepted sense and insurable risk—as well as the recent case *Avrahami v. Commissioner*, to determine whether the transactions at issue constituted insurance for federal tax purposes. The Tax Court focused on two criteria—risk distribution and insurance in the commonly accepted sense (discussed in more detail below)—and found that the taxpayer had failed to meet either criteria. Because reasonable cause existed, however, the imposition of non-accuracy-related penalties was not appropriate.

- ***Risk distribution***

Risk distribution occurs when an insurer pools a sufficiently large enough number of independent risks such that the risk of loss from any single claim will be spread among a number of insured. Here, the taxpayer argued that it distributed risks with the fronting companies through the arrangements with the respective reinsurance pools.

As an initial matter, before risk distribution can occur, the arrangement must be treated as bona fide insurance. For a number of reasons, the arrangements between the parties did not qualify as bona fide insurance. First, although not technically a circular flow of funds, the net premiums paid by the manufacturer to the fronting companies were nearly equal to the amount of premiums ceded to the taxpayer from the fronting companies.

Second, the contracts between the manufacturer and the fronting companies were not arm's length contracts. Of note, the premiums paid on the contracts were higher than expected. Additionally, the claims reporting period (and particularly the seven-day period after the expiration of the policy) was inconsistent with what would be found in an arm's length contract.

Third, the premiums for the policy were not actuarially determined. The chief underwriter was not an actuary, and none of the analysis related to premium determinations was consistent with actuarial principles.

- ***Insurance in the commonly accepted sense***

Whether an arrangement is considered insurance in the commonly accepted sense depends on a number of non-exclusive factors—for example, whether the company was organized, operated, and regulated as an insurance company; whether the company was adequately capitalized; whether policies were valid and binding; whether premiums were reasonable and the result of arm's length transactions; and whether claims were paid are all considerations.

Here, although the Tax Court acknowledged that the taxpayer was adequately capitalized, none of the other factors above supported a conclusion that the arrangement between the manufacturer and the taxpayer was insurance in the commonly accepted sense. First, although the taxpayer was organized and regulated as an insurance company, it was not operated as an insurance company. For example, the taxpayer did not have a process for claims and did not pay any claims to the manufacturer. Furthermore, the taxpayer's assets were unusual compared to typical insurance companies—particularly the life insurance policies in later years. The court noted that an insurance company would not generally invest a significant portion of its capital into assets that the company could not readily access to pay claims. Second, none of the policies was timely issued. Although this is not uncommon in the insurance industry, the fact that not a single policy was issued timely weighed against the taxpayer. Third, as noted above, the unreasonableness of the premiums and the inadequacy of the claims process weighed against the taxpayer.

- ***Effect of ruling***

Because the arrangement was not insurance, the taxpayer's section 831(b) election was invalid. As such, the taxpayer was required to recognize the premiums it received as income.

With respect to the individual taxpayers, such individuals were not entitled to deduct the purported premium payments or any fees as payments for insurance because the payments were not for insurance. Although the individuals argued that such payments would nevertheless be deductible as payments for indemnification, the court found that such payments were not ordinary and necessary business expenses. In particular, the manufacturer's failure to file claims for losses that were covered under the policies suggested that there was no intent to seek indemnification for covered losses.

KPMG observation

Given the facts of the case, it is not surprising that the Tax Court's result mirrors recent section 831(b) cases. Tax professionals note that the memorandum's analysis is structured similarly to the analysis in *Avrahami v. Commissioner*, a case that also found that a taxpayer did not qualify as an insurance company because: (1) risk distribution was not satisfied (because there was no bona fide insurance); and (2) there was no insurance in the commonly accepted sense (because the company did not operate as an insurance company and because the premiums were unreasonable).

The Tax Court's discussion does provide additional points of reference for some of the most fact-intensive portions of the four-part insurance company analysis. Although some of facts in this case are fairly taxpayer unfavorable, they nevertheless are helpful in determining what is and what is not permissible for an insurance company in general and for section 831(b) captives specifically (which are more likely to have similar-type facts to this case).

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