SOCIETY OF ACTUARIES

Article from

Taxing Times

October 2018
Volume 14, Issue 3

Captive Evaluation in *Reserve Mechanical*

By Jean Baxley and Catherine Moore

Many public and non-public entities use closely held insurance companies, often referred to as captive insurance companies, to ensure the risks of their affiliates. These captives may or may not qualify as insurance companies for U.S. federal income tax purposes. Section 816(a), which is specifically cross-referenced in section 831(c), defines an "insurance company" as "any company more than half the business of which during the taxable year is the issuing of insurance or annuity contracts or reinsuring of risks underwritten by insurance companies."[1] Moreover, to qualify as insurance for U.S. federal tax purposes, an arrangement must satisfy a number of judicially created tests. Among the nonexhaustive list of requirements are: (1) presence of insurance risk; (2) the shifting of risk from the insured to the insurer; (3) the distribution of risk by the insurer; and (4) other considerations that are grouped together as "commonly accepted notions of insurance." Corporations that satisfy these requirements are entitled to the special benefits afforded to a captive arrangement (*e.g.*, deductibility of premiums and "insurance company" treatment). Each arrangement's specific facts and circumstances should be considered when evaluating qualification as an insurance company for tax purposes. Recently, in *Reserve Mechanical Corp. v. Commissioner*,[2] the U.S. Tax Court addressed insurance company qualification for a captive entity and concluded that the taxpayer's arrangement did not constitute insurance for the reasons discussed below.[3]

FACTUAL OVERVIEW

Reserve, the Captive

The qualification of captives as insurance companies has been litigated for many years, most recently in *Reserve Mechanical*. Reserve Mechanical Corp. (f.k.a. Reserve Casualty Corp.) ("Reserve") was organized in 2008 in Anguilla and had a section 953(d) election in place for 2008–10, the tax years at issue. Reserve was wholly owned by Peak Casualty Holdings LLC ("Peak"), an Idaho S corporation. Peak was owned by two U.S. persons who each had a 50 percent interest in the stock of Peak and each of whom acted as a director for Reserve.

Peak was engaged in the business of distributing, servicing, repairing and manufacturing equipment used for underground mining and construction. During the relevant years, Peak had between 13 and 17 employees. At all times during the relevant years, Peak maintained third-party insurance coverage for general liability, workers' compensation, commercial property, inland marine, automobile and international risk.

Peak's owners also equally co-owned 100 percent of the membership interests in two partnerships: RocQuest LLC ("RocQuest") and ZW Enterprises LLC ("ZW"). RocQuest held various real estate interests including the property it leased to Peak. ZW was organized to help finance a loan to a former employee. In exchange for the assistance, ZW owned 10 percent of the former employee's business.

Capstone

The owners of Peak were introduced to Capstone, a "turnkey" services provider for captive administration and management. Capstone was formed by the managing partner of a law firm that provided legal services to Capstone clients.

Capstone provided a captive feasibility study to Peak that concluded "the viability of a small captive insurer . . . to address the insurance and risk management issues discussed herein is feasible, reasonable, and practical, and is the best alternative risk mechanism option for the proposed insured." The feasibility study was issued jointly with Willis HRH of Houston, an insurance broker and risk management consulting firm. Following the feasibility study, Reserve was incorporated on Dec. 3, 2008. On Dec. 10, 2008, Reserve received an initial capitalization of $100,000.

From 2008–10, Reserve issued direct written insurance policies including coverage for 11 to 13 different lines such as excess directors and officers liability, excess pollution, loss of major customer, excess cyber risk and product recall. Peak, RocQuest and ZW were the named insureds on each policy. All of the

policies issued showed one premium price but did not allocate the amounts to be paid by each insured. The policies listed PoolRe Insurance Corp. ("PoolRe") as the stop-loss insurer for the coverage. Additionally, each policy stated that it applied only after other (presumably commercial) coverages were exhausted.

Only one claim, for loss of a major customer, was made from 2008–10. The initial claim was for $164,820 and Reserve paid the total amount of the claim once the insured had signed a release. Subsequently, an extended claim was made and Reserve issued another claims payment on the same loss event in the amount of $175,000.

PoolRe

PoolRe is an insurance company domiciled in the British Virgin Islands. PoolRe's operations were administered by Capstone. For each of the tax years in issue, Reserve and PoolRe executed a joint underwriting stop-loss endorsement that applied to all direct written policies that Reserve issued. Pursuant to these agreements, PoolRe agreed to serve as a joint underwriter and stop-loss insurer for the direct written policies that Reserve issued. According to the stop-loss agreement, Reserve was the lead insurer with respect to the policies and PoolRe assumed an amount of excess risk in exchange for 18.5–19.9 percent of the total combined premiums due from the insureds. During the years at issue, PoolRe also entered into similar endorsements for approximately 400 policies that between 51 and 56 Capstone clients issued; that covered in the aggregate around 150 insureds.

From these various endorsements, PoolRe pooled the premiums that it was entitled to receive and executed reinsurance agreements designed to redistribute them to Capstone entities. Reserve and the other Capstone entities each executed with PoolRe a quota-share reinsurance policy pursuant to which each entity agreed to assume coverage for a specified portion of the risks that PoolRe had assumed according to the stop-loss endorsements. The quota share Reserve assumed was calculated so that Reserve was entitled to receive payments from PoolRe equal to the premiums that PoolRe was entitled to receive from Peak and the other insureds pursuant to the stop-loss endorsement.

CreditRe

For the relevant tax years, Reserve executed with PoolRe a credit insurance coinsurance contract, under which Reserve agreed to assume a small portion of risk that PoolRe had assumed from an unrelated company, Credit Reassurance Corp. Ltd. ("CreditRe"). The coinsurance contracts stated that CreditRe ceded to PoolRe a *pro rata* share of the liability and premiums associated with its large pool of vehicle service contracts (these contracts originated with a large U.S. direct insurer). Under the coinsurance contract, Reserve reinsured from 0.9100 to 1.1576 percent of PoolRe's annual liability. PoolRe executed similar coinsurance contracts with other Capstone clients.

TAX COURT ANALYSIS AND TAKEAWAYS

Risk Distribution

The first issue addressed by the Tax Court was risk distribution. Based on the number of insureds and the total number of independent risk exposures, the Court concluded that the policies Reserve issued directly were insufficient to distribute risk. In reaching this conclusion, the Court referenced *Rent-A-Center*,[4] *Avrahami*[5] and *Securitas*[6] but did not provide a bright line test for how many entities (*i.e.*, legal entities) and/or how many independent risk exposure units (*i.e.*, number of employees, vehicles, locations) would be sufficient to achieve risk distribution.

> It is likely that the IRS will continue to challenge the validity of captive arrangements.

The Court then turned to the stop-loss endorsements, quota-share reinsurance arrangement and credit coinsurance contracts as they relate to risk distribution. Reserve stated that through these arrangements, 30 percent of its gross premiums for each tax year was from insuring unrelated parties.[7] Citing *The Harper Group*, Reserve claimed that this percentage of third-party premium income was sufficient to achieve risk distribution.[8] To determine if risk distribution was achieved, the Court first looked at whether PoolRe was a legitimate insurance company. As stated above, the quota share Reserve assumed was calculated so that Reserve was entitled to receive payments from PoolRe equal to the premiums that PoolRe was entitled to receive from Peak and the other insureds pursuant to the stop-loss endorsement. The Court also noted: (1) Reserve did not have any losses related to the quota-share arrangement; (2) there was no evidence that these arrangements were priced on an arm's length standard; and (3) there was no evidence that PoolRe was likely to ever suffer any economic loss pursuant to the stop-loss arrangements. Taking the above into account, the Court found that: (1) at the end of each year, Reserve's economic position had not changed; (2) risk distribution was not achieved; (3) Reserve was created solely to realize tax benefits; and (4) the agreements with PoolRe were not bona fide insurance agreements. Finally, the Court held that the risk, if any was indeed transferred to Reserve from PoolRe, was *de minimis* (in fact, the Court hinted that there was a failure to produce evidence related to the underlying coinsurance agreements). Because risk distribution was not achieved, the Court concluded that the Reserve arrangement could not constitute insurance for U.S. federal tax purposes.

Commonly Accepted Notions of Insurance

As a supplement to the first holding on risk distribution, the Court also found that the Reserve arrangement did not constitute insurance in the commonly accepted sense. To reach this ruling the court looked at the following factors: (1) organization, operation and regulation; (2) adequate capitalization; (3) valid and binding policies; (4) reasonableness of premiums; and (5) payment of claims.

Organization, operation and regulation. The court found that apart from satisfying the formalities of organization and compliance with legal requirements, Reserve was not operated as an insurance company. The court noted that Reserve had no employees, its directors knew nothing about its operations and policies, it had no activities in Anguilla, and that management was handled entirely by Capstone. Moreover, there was no evidence of due diligence related to the policies Reserve issued and Capstone's feasibility study was not complete when Reserve issued the direct policies for 2008 and 2009. Additionally, the Tax Court found there was no evidence that Reserve evaluated the risks assumed before executing the quota-share policies. The Court seemed to impose a "due diligence" standard wherein purported captive insurance companies must demonstrate that they behave like insurers would with respect to underwriting and pricing products for unrelated parties.

Adequate capitalization. The Court held that Reserve was sufficiently capitalized as it met the minimum capitalization requirements of its domicile, Anguilla.

Valid and binding policies. The Court held that Reserve's direct written policies contained terms to make them valid and binding insurance. The Court also noted that these were "cookie cutter" policies that in many instances were not reasonably suited to the needs of the insureds. Accordingly, this factor was determined to be neutral.

Reasonableness of premiums. For this factor, the Court noted that Reserve's directors always approved the premium amounts recommended by Capstone. Though evidence was produced that indicated the methodology for determining premium amounts, the Court noted that there were a number of factors indicating that the premiums were not reasonable in relation to the risk of loss. For 2007, Peak paid insurance expenses of $95,828. For 2008, Peak and two affiliates that had no active business operations paid premiums of $412,089 in addition to the premiums Peak paid for third-party commercial insurance. The Court also noted that seven of the 2008 policies had retroactive dates. In summary, the Court found that the facts did not reflect that Peak had a genuine need for acquiring additional insurance during the relevant tax years and, accordingly, the premiums were determined not to be reasonable.

Payment of claims. The Court held that this factor slightly favored Reserve but that evidence relating to payment of claims was not overwhelming.

CONCLUSION

In summary, *Reserve Mechanical* provides some additional considerations for taxpayers concerned with meeting the risk distribution and commonly accepted notions of insurance standards for captive qualification. Ultimately, it is likely that the IRS will continue to challenge the validity of captive arrangements and the Tax Court will continue to apply the same judicial tests as were applied in *Reserve Mechanical*. As mentioned above, however, each captive arrangement is to be evaluated taking into account the relevant facts and circumstances. ■

Disclaimer: The article does not constitute tax, legal or other advice from Deloitte Tax LLP, which assumes no responsibility with respect to assessing or advising the reader as to tax, legal or other consequences arising from the reader's particular situation.

Jean Baxley is a managing director in the Washington National Tax office of Deloitte Tax LLP and may be reached at *jebaxley@deloitte.com*.

Catherine Moore is a manager in the Washington National Tax office of Deloitte Tax LLP and may be reached at *catmoore@deloitte.com*.

ENDNOTES

1 Section 831(c), which refers to section 816(a), was added by The Pension Funding Act of 2004 (29 U.S.C. 1001) to incorporate pertinent section 816 definitions to specifically apply the definition of an insurance company to property and casualty insurance companies, including captive insurers.

2 *Reserve Mechanical, f.k.a. Reserve Casualty Corporation v. Commissioner*, T.C. Memo 2018-86 (June 18, 2018).

3 *See also Rent-A-Center, Inc. v. Commissioner*, 142 T.C. 1 (2014); *Securitas Holdings, Inc. v. Commissioner*, T.C. Memo 2014-255; and *Avrahami v. Commissioner*, 149 T.C. 7 (2017).

4 *Rent-A-Center, Inc. v. Commissioner*, 142 T.C. 1 (2014).

5 *Avrahami v. Commissioner*, 149 T.C. 7 (2017).

6 *Securitas Holdings, Inc. v. Commissioner*, T.C. Memo 2014-255.

7 We note the Tax Court previously invalidated a pooling arrangement in *Avrahami*. The IRS has long disfavored such arrangements and taken the position such arrangements do not successfully achieve risk distribution.

8 *The Harper Group v. Commissioner*, 96 T.C. 45, *aff'd*, 979 F.2d 1341 (9th Cir. 1992).