Rent-A-Center, Inc. v. Commissioner: A divided Tax Court allows a deduction for premiums paid to a captive insurance company

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In brief

In a divided opinion, a majority of the U.S. Tax Court in *Rent-A-Center v. Commissioner,* 142 T.C. 1 (January 14, 2014) held that payments made by a parent company to a subsidiary insurance company on behalf of other wholly-owned subsidiaries were properly deductible as insurance premiums. This long-awaited decision is not only the first captive insurance case in several years, but also the first since the IRS abandoned its economic family theory in 2001 and replaced it with other, safe-harbor rulings. This favorable opinion could alter the future design and operation of captive insurance arrangements and the dynamics of ongoing IRS examinations and appeals.

In detail

Background

Rent-A-Center, Inc. (RAC) is the parent of a group of approximately 15 affiliated subsidiaries. In order to reduce insurance costs and obtain coverage that may in the future be unavailable, RAC in 2002 incorporated and capitalized Legacy Insurance Co., Ltd. (Legacy), a wholly owned Bermudian subsidiary registered as a class 1 insurance company with the Bermuda Monetary Authority. RAC proceeded to enter into policies with both Legacy and other third-party insurance companies on behalf of its subsidiaries.

The policies that Legacy issued covered workers compensation, automobile, and general liability risks. Premiums under the policies were determined using actuarial forecasts. Although RAC was a listed policyholder on the Legacy policies and paid the annual premium, no premium was allocated to RAC because it did not hold any assets that gave rise to the insured risks. Rather, RAC established a monthly rate between it and its subsidiaries based on factors such as each subsidiary's payroll, number of vehicles, and the number of stores each subsidiary owned.

Upon examination, the IRS concluded that amounts RAC paid to Legacy on behalf of its other subsidiaries were not deductible as insurance premiums under Section 162. This determination was based upon a number of factors that the IRS historically has cited to disallow arrangements as insurance:

- The parent corporation was the listed policyholder and paid the premiums on behalf of its subsidiaries;
- The parent guaranteed the liquidity of the captive insurer's deferred tax assets (DTAs);
- The captive insurer invested in nondividend-paying treasury stock of its parent; and
- Risks were concentrated in a relatively small number of sibling corporations.

As a result, the IRS asserted a deficiency of over $43 million.

Majority opinion

A majority of the Tax Court disagreed with the Service's determination that the payments to Legacy were not deductible insurance premiums.

Writing for the majority, Judge Foley found that Legacy was not a sham because, even though Federal income tax consequences were considered, the formation of Legacy was not a tax-driven transaction. To the contrary, the formation of Legacy was premised on a "myriad" of legitimate business considerations. This conclusion was further supported by the absence of an impermissible circular flow of funds, premium-to-surplus ratios that were commercially reasonable, and Legacy's operation as a bona fide insurance company.

The majority opinion went on to conclude that payments to Legacy constituted insurance premiums based on criteria the courts have applied in other cases, such as *AMERCO v. Commissioner,* 96 T.C. 18 (1991), *aff'd* 979 F.2d 162 (9th Cir. 1992), and *Harper Group v. Commissioner,* 96 T.C. 45 (1991), *aff'd* 979 F.2d 1341 (9th Cir. 1992):

- Insurance Risk. The IRS conceded that workers compensation, automobile, and general liability risks are insurance risks;
- Risk shifting. The majority concluded that the requirement of risk shifting was met, based on an acknowledgement of the Sixth Circuit's conclusion in *Humana v. Commissioner* that brother-sister arrangements may shift risk. Under the facts presented, Legacy was a separate, independent, viable entity that was financially capable of meeting its obligations, and the policyholders did not own Legacy, so a payment on a claim would not reduce their value. According to the majority, neither the parent's guarantees nor Legacy's investment in treasury stock affected this conclusion;
- Risk Distribution. The majority concluded that the requirement of risk distribution also was met, based on the thousands of store locations, employees, and vehicles that were insured. Significantly, the majority did not analyze risk distribution based upon the number of insured entities, nor did it acknowledge the IRS position in Rev. Rul. 2005-40 and Rev. Rul. 2002-90, both of which analyze risk distribution based upon the number of policyholders rather than the number of underlying risks; and
- Insurance in the Commonly Accepted Sense. In two sentences, the majority concluded the arrangement constituted insurance in the commonly accepted sense based upon Legacy's capitalization, regulations, and operation as an insurance company.

Because the arrangement qualified as insurance, the payments under the arrangement were deductible as insurance premiums under section 162 of the Internal Revenue Code.

In a concurring opinion, Judge Buch agreed with the result but thought it unnecessary to address whether an arrangement between sibling corporations could qualify as insurance, as the IRS abandoned that argument in 2001.

Dissenting Opinions

Judges Halpern and Lauber wrote dissenting opinions.

Judge Lauber criticized the majority for omitting facts that would undermine the ultimate conclusions, and for drawing incorrect conclusions as to the effect of the parental guarantee and capitalization on risk shifting, and as to conformity to insurance industry standards.

Both Judges Halpern and Lauber took exception to the majority's apparent overruling of the court's prior conclusion in *Humana Inc. & Subs. v. Commissioner,* 88 T.C. 197 (1987), *aff'd in part and rev'd in part,* 881 F.2d 247 (6th Cir. 1989), that an arrangement between sibling corporations cannot constitute insurance. The Sixth Circuit reversed the Tax Court on that issue. *Rent-A-Center* is appealable to the Fifth Circuit.

The takeaway

On balance, the opinion in *Rent-A-Center* is a favorable development for companies with captive insurance programs or that are considering them. Although the IRS may decide to appeal the case, the opinion will in some cases confirm the legitimacy of existing captive insurance arrangements, and in other cases provide clearer guidance for companies deciding whether to establish captive insurance programs. For example, in some cases the opinion may make it easier for companies to form tax-qualified insurance arrangements with a smaller number of policyholders than previously thought necessary. In other cases, the opinion may make it easier for companies to invest in securities of an affiliate, or to rely on a guaranty to satisfy the minimum capital requirements of the relevant jurisdiction. Companies that are under IRS examination or in appeals on their captive insurance programs also may find their positions are stronger as a result of the opinion.

Let's talk

For more information on how the decision in *Rent-A-Center* could affect your business, please contact one of the individuals listed below:

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