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Beyond The Bright-Line Test: *Rent-A-Center v. Commissioner* – Long-Awaited U.S. Tax Court Decision Provides More Heat Than Light On What Constitutes "Insurance" Between Related Parties

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In 1977, IRS issued Rev. Rul. 77-316,[1] which held that when a corporate parent insures risks with a wholly owned subsidiary, the transaction *per se* cannot be characterized as insurance for federal tax purposes because the risk shifting and risk distribution that the U.S. Supreme Court has identified as the essential elements of an "insurance" transaction are lacking.[2] Since then, taxpayers and their tax and business advisors have struggled to craft transactions which will pass IRS muster.

The stakes are high. If the transaction is "insurance" and the related party providing the coverage is respected as an "insurance company" for U.S. tax purposes, the payor entity (either the corporate parent or one or more of its subsidiaries) receives a current income tax deduction for the full "premium" amount rather than having any deduction delayed until a "loss" occurs and limited to the amount of the loss. On the other end of the transaction, if the recipient subsidiary (whether a U.S. corporation or a foreign one) is respected as an "insurance company," it enjoys tax advantages typically unavailable outside the insurance context.

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In Rev. Rul. 77-316, IRS embraced the "economic family theory," which holds that a subsidiary can never provide true insurance to its parent or to its brother-sister entities because they represent the one economic family so that the one who bears the ultimate economic burden of the loss is the same person who suffers the loss so there is no risk shifting.[3]

For the next 15 years, the federal courts decided numerous captive insurance cases. Most of these cases were brought in the U.S. Tax Court. Over that time, the IRS's efforts met with only modest success. The IRS universally prevailed in denying deductions to a parent that "insured" its risks with a wholly owned insurance subsidiary that only insured the risks of the parent.[4] However, its "economic family" theory was never completely embraced except in the Tenth Circuit.[5] In cases involving other fact patterns, the results varied. The Tax Court viewed brother-sister captive transactions as the same as parent-subsidiary ones and denied deductions for the premiums paid while a number of other courts held that these transactions were "insurance." Later cases focused on whether (and, if so how much) third-party business provided sufficient risk shifting and risk distribution in either the parent-subsidiary or brother-sister situation.[6]

In 2001, IRS formally abandoned reliance on the economic family theory as its litigation position. [7]

Finally, in 2002, IRS announced that it would no longer disallow tax deductions for insurance premium payments between brother-sister entities in all cases but would instead focus on the facts and circumstances of each case in determining whether the transaction involved "insurance." [8]

In the hypothetical facts of Rev. Rul. 2002-90, IRS found that "insurance" exists where the parent forms an insurance subsidiary and provides it with adequate capital and the subsidiary later provides coverage for 12 of the parent's operating subsidiaries in return for arm's length premiums established under customary rating formulas used in the insurance industry. IRS's hypothetical transaction did not involve the parent or any related party providing guarantees or indemnification to any third party for the benefit of the captive and envisioned all parties to the transaction conducting themselves in a manner consistent with the way an insurance relationship between unrelated parties would be carried on. Later rulings have expanded on the types of transactions and amounts of unrelated business that might suffice to pass tax muster.[9]

Over the years since 2002, some tax planners and financial advisors have touted establishing a captive insurance company as a mechanism for achieving estate planning or asset protection goals rather than providing necessary insurance coverage. In its more aggressive forms, such "planning" has been reminiscent of the tax shelter transactions of the late 1990s and early 2000s, where huge taxpayer deductions were created by financial advisors for clients who, in reality, continued to be in the same economic position as before except for paying less tax.

IRS gradually became aware of the potential abuses and, in the past several

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years, has again greatly increased its scrutiny of captive insurance arrangements.

This has involved audits of both corporate taxpayers using captives as well as "promoter" examinations of firms that manage them. Several criminal investigations and prosecutions have also been initiated where the facts were indicative of tax-abusive transactions or factual shams. A number of cases involving captive insurance arrangements are pending in the U.S. Tax Court.

In January 2014, a sharply divided Tax Court upheld Rent-A-Center's ("RAC") use of a Bermuda-based captive (Legacy) to insure the workmens' compensation, general liability and automobile liability risks of 15 of its operating subsidiaries.[10] The subsidiaries operated approximately 3,000 RAC stores in all 50 states as well as in the District of Columbia, Puerto Rico and Canada, employed almost 20,000 people and owned over 8,000 vehicles. RAC and its operating subsidiary filed consolidated income tax returns for the years 2003-2007.

Legacy did no third-party business and was wholly owned by RAC, the corporate parent of all of its "insureds." This presented the Tax Court with a classic "brother-sister" captive insurance situation for the first time since 1987 when the Tax Court decided the *Humana* case and held that brother-sister captive insurance transactions, like parent-subsidiary ones, cannot, by definition, shift and/or distribute risk and are not "real insurance." In *Humana,* the Sixth Circuit upheld that Tax Court's disallowance with respect to the parent entity but reversed regarding the brother-sister entities and held that those transactions represent "real" insurance, a position IRS later accepted in Rev. Rul 2002-90.

Judge Foley presided at the trial of the *RAC* case and found that the facts and circumstances of the case supported allowing a deduction for "insurance" despite a) the presence of RAC's guarantee to the Bermuda regulators in order to allow Legacy to meet Bermuda's minimum solvency requirements, b) the payment of premiums and claims largely by journal entry, c) Legacy's lack of liquid third-party investments in favor of buying its parent's treasury stock and d) a much higher premium-to-surplus ratio than commercial insurers.

In Judge Foley's view, these issues did not alter the fact that the risks covered were true insurance risks, the premiums charged were actuarily determined and were reasonable in amount, and that RAC had valid and substantial business reasons for needing to form Legacy.[11] Judge Foley was highly critical of the Tax Court's *Humana* decision as to brother-sister transactions and clearly felt *Humana* was wrongly decided, although he did not expressly say it was being overruled.[12] These comments led to the opinion being reviewed by the entire Tax Court under its Court Conference procedures. Six other Tax Court judges agreed that the deductions should be allowed.

Judge Buch (one of the six judges) wrote a separate concurring opinion in which three other judges joined. He agreed with Judge Foley's "concise opinion" setting forth the facts and circumstances that led him and the rest of the majority to find that the payments constituted deductible "insurance" premiums but said it was unnecessary for the Tax Court to overrule its *Humana* decision because IRS had long ago ceased arguing that a brother-sister captive arrangement is *per se* not insurance.[13]

There were dissenting opinions issued by two judges with which four other Tax Court judges agreed, so that the final vote was 10-6 in favor of upholding the claimed deductions.

Judge Lauber wrote a lengthy dissent in which he analyzed the same facts that Judge Foley had analyzed and found to support Rent-A-Center's position. Judge Lauber bluntly termed Judge Foley's analysis "conclusory" and unpersuasive. Judge Lauber found these same facts and circumstances showed that Legacy did not enter into a bona-fide arm's length insurance arrangement with its sister entities, was inadequately capitalized, did not function the way a "real" insurance company would and that "the totality of the facts and circumstances could warrant the conclusion that Legacy was a sham."[14]

Judge Halpern, in a separate dissenting opinion, was also critical of Judge Foley for unnecessarily revisiting the *Humana* decision. He further appeared to agree with Judge Lauber's analysis that the facts and circumstances showed that what RAC did was not "insurance" saying "whether I describe Judge Foley's analysis as concise or as conclusory, simply put, there is insufficient depth to it to persuade me to join in his findings."[15]

While *Rent-A-Center* provides the reader with a good summary of the evolution of both the Tax Court's and IRS's position on captive insurance, the opinion boils down to a Tax Court referendum on the trial judge's view of the particular facts of that case in the Court Conference process. Clearly, RAC would have lost if Judge Lauber or Judge Halpern was the trial judge and the case was not put before the court as a whole.

The lengthy opinion sheds little if any light on thornier questions such as whether what was "insured" is, in fact, an insurable risk rather than a business or financial risk or whether loans or other non-premium transactions between the parent and the insurance subsidiary might lead one to conclude the entire arrangement is a tax-motivated sham. These issues (and others such as the use of cell captives) were not present in the RAC case although they are clearly issues in some other cases IRS is currently either auditing or investigating.

1. Rev. Rul. 77-316, 1977-2 C.B. 53.

2. *Helvering v. LeGierse*, 312 U.S. 531, 539 (1941).

3. Rev. Rul. 77-316, 1977-2 C.B. at 54.

4. *Carnation v. Commissioner*, 71 T.C. 410 (1978) aff'd 640 F.2d 1010 (9th Cir. 1981); *Clougherty Packaging Corp. v. Commissioner,* 84 T.C. 948 (1985) *aff'd* 811 F.2d 1297 (9th Cir. 1986).

5. *Beech Aircraft Corp. v. United States,* 797 F.2d 920 (10th Cir. 1986); *Stearns-Roger Corp. United States*, 774 F.2d 414 (10th Cir. 1985).

6. *Humana, Inc. & Subsidiaries v. Commissioner*, 881 F.2d 247 (6th Cir. 1988) *rev'ing in part* and *aff'g in part,* 88 T.C. 197 (1987), 6th Cir. reverses Tax Court and holds (risk shifting and risk distribution present where captive insures multiple brother-sister entities risks); *Harper Group v. Commissioner*, 96 T.C. 45 (1991), *aff'd* 979 F.2d, 1341 (30% unrelated risks sufficient to have risk shifting and risk distribution).

7. Rev. Rul. 2001-31, 2001-1 C.B. 1349.

8. Rev. Rul. 2001-90, 2002-2 C.B. 985.

9. Rev. Rul. 2002-89, 2002-2 C.B. 984; Rev. Rul. 2002-91, 2002-2 C.B. 991; Rev. Rul. 2005-40, 2005-2 C.B. 4.

10. *Rent-A-Center, Inc. v. Commissioner*, 144 T.C. No. 1 (Jan. 14, 2014).

11. Slip Op. at pp. 39-40.

12. Slip Op. at pp. 32-33.

13. Slip Op. at p. 50.

14. Slip Op. at p. 74.

15. Slip. Op. at p. 52.