Recent Significant Cases

F&I Reinsurance and Product Conference
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1

OVERVIEW

- Definition of Insurance for Tax Purposes
- Cases Litigated in U.S. Tax Court to Date
- Review of Tax Court opinions
  - *Rent-A-Center* (2014)
  - *RVI Guaranty (2015)*
  - *Avrahami (2017)*
  - *Reserve Mechanical (2018)*
  - *Syzygy (2019)*
- Future Opinions

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INSURANCE DEFINED

- Risk Shifting
- Risk Distribution
- Insurance in its Commonly Accepted Sense
- Insurance Risk

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Rent-A-Center

- 142 T.C. 1 (2014) (Judge Foley) (TP Win)
- RAC was parent of 15 related subsidiaries
- The subsidiaries rented, sold, and delivered home electronics, furniture and appliances
- Captive insured workers compensation, automobile and general liability

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Rent-A-Center Risk Distribution

- 60% of risk was from one of the subsidiaries
- 90% of risk was in four subsidiaries
- No premiums from unrelated parties was paid to Captive

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Rent-A-Center: Determination

Tax Court found:

- Valid business purposes for forming
- Focused on number of risk exposures, not the entities
  - Subsidiaries owned at least 2,623 stores
  - At least 14,300 employees
  - Operated at least 7,143 insured vehicles
  - Operated in all 50 states

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Rent-A-Center: Determination

- Tax Court focused on “statistically independent risks” rather than entities
- No impermissible circular flow of funds
- Premium to Surplus Ratio was acceptable
- Captive was a bona fide insurance company
- Policies involved insurance risk and shifted that risk

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R.V.I. Guaranty

- 145 T.C. 209 (2015) (By Judge Lauber) (TP Win)
- Provided residual value insurance to owners of leased assets
- Is residual value insurance truly “insurance” for tax purposes
- IRS position: “RVI policies did not transfer *enough* risk of loss because losses were relatively unlikely to occur.”

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R.V.I.: Risk Shifting

Tax Court stated:

"This argument is unpersuasive on both theoretical and evidentiary grounds. Both parties' experts analogized the RVI policies to 'catastrophic' insurance coverage …. An insurer may go many years without paying an earthquake claim; this does not mean that the insurer is failing to provide 'insurance.'"

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R.V.I.: Claims/Loss History

- IRS claim: loss ratio low
- Tax Court: it bore a significant risk of loss
- From inception through 2006 - RVI's ratio was about 28%
- From inception through 2013 – RVI's ratio was about 34%
- Some years low, some as high as 98% (during the 2008 financial crisis)
- "All in all, we conclude that the level of risk transferred to RVI under these policies was more than sufficient to treat them as 'insurance contracts' for Federal income tax purposes."

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R.V.I.: Risk distribution

Risks were distributed across

- Asset classes or segments (passenger vehicle, commercial real estate, and commercial equipment)
- Geographic area
- Temporally distributed (various lease lengths)

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R.V.I.: Risk distribution

- IRS argued "RVI policies do not sufficiently distribute risk because some systemic risks, like major recessions, could cause insured assets to decline in value simultaneously."
- Tax Court:
  - The legal requirement for 'insurance' is that there be meaningful risk distribution; perfect independence of risks is not required.
  - We have no difficulty concluding … that the RVI policies accomplish sufficient risk distribution to be classified as 'insurance' for Federal tax purposes.

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R.V.I.: “Insurance risk” vs. “Investment risk”

Tax Court first looked at whether there was underwriting risk:

- Fortuitous risk existed
- Clear underwriting risk, exposure, the risk that the premiums charged might not be enough to cover claims paid
- RVI's business model made certain to price product so that it would be bought and also that there be sufficient pool of premiums to cover the aggregate insured losses

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R.V.I.: Investment risk

- IRS contended that protection against investment losses are not “insurance”
- Tax Court rejected this argument
  - For more than 80 years, the States have regulated as “insurance” contracts that provide coverage against decline in the market values of particular assets.
  - Petitioner’s regulators and external auditors have uniformly concluded that its policies involve “insurance risk.”

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R.V.I.: "Pure Risk" theory

IRS expert

- Argued the coverage was not a "pure risk", i.e., a situation where only outcome is "loss" or "no loss"
- Argued insureds had possibility of gain if leased assets appreciated in value so this was "speculative risk"
- Relied only on statements of general principles from college textbooks and disregarded contrary views

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R.V.I.: "Pure Risk" theory

- Tax Court described distinction as "essentially metaphysical"
- Inconsistent with Federal tax treatment as "insurance" of:
  - Mortgage guaranty insurance
  - Lease guaranty insurance
  - Municipal bond insurance

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R.V.I.: Comparison to "Put" Options

- IRS: RVI should be compared to "put" options guarding against downturns in stock
- Tax Court:
  - Considered this "little more than a simile"
  - "[A] product can be 'insurance' even though competing products exist in the financial marketplace."
  - "The existence of other strategies does not mean that the strategy chosen is not 'insurance' or that product purchased involves no 'insurance risk.'"

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R.V.I.: Implications

- Significant loss for IRS
- Analysis shows that mere characterization as "financial" or "investment" loss isn't the test; the nature of fortuity, amount at risk, and how premiums are calculated are what matters
- Analogies to financial products won't persuade
- Cited repeatedly in subsequent cases

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AVRAHAMI - OVERVIEW

- 105-page opinion by the United States Tax Court issued on August 21, 2017
  - First court case involving an insurance company taxed under section 831(b)
  - Based on facts and circumstances
- Court held that the taxpayers did not enter into a valid insurance transaction
  - No risk distribution
  - Not insurance in its commonly accepted sense
    - Not operated as an insurance company
    - Policies had “unclear and contradictory” terms
    - Premiums were “wholly unreasonable”
  - Premiums not otherwise deduction as a business expense
  - No penalties upheld against taxpayers
  - Foreign-domiciled captive lost its election, but parties agreed no U.S. income
- No appeal filed by taxpayers

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AVRAHAMI – FACTS IN THE OPINION

- Insureds were three jewelry stores and three shopping centers
- Captive was domiciled in St. Kitts
- Insureds purchased insurance from Feedback
  - Commercial premiums paid in 2006 were $150,000; premiums increased to more than $1.1 million in 2009
- Insureds purchased terrorism coverage from Pan-American
  - Pan-American insured other unrelated companies for terrorism risk, 85 and 101 for the years before the Court
  - Pan-American reinsured a pro-rata share of all risks to Feedback and other insurance companies affiliated with Pan-American’s insureds
  - Policy covered terrorism NBCR
  - Pricing for each insured used the same rate on line regardless of location

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AVRAHAMI – FACTS IN THE OPINION

- Feedback risks
  - Direct (related) roughly 70%; reinsurance (unrelated) roughly 30%
- Mr. Avrahami was under the impression that only the amount of premium paid into Pan-American was at risk
- No Claims paid by Feedback until after IRS audit began
- "Claims Feedback did receive were dealt with in questionable ways"
  - Approved despite being filed late
  - Lack of evidence about the cause of damage
- Feedback loaned $2,530,000 (about 65% of its assets) to Belly Button Center LLC, which was owned by the Avrahamis' children (unbeknownst to them)
  - Neither principal nor interest was due for several years
  - Did not seek approval by the regulators as required by the St. Kitt's Captive Insurance Companies Act of 2006

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AVRAHAMI – RELATED RISK DISTRIBUTION

- The Court considered affiliated risks
  - Government's expert: must insure 35 entities
  - Taxpayer's expert: must insure 12 entities
  - Court: The 3 or 4 insureds were not sufficient
- The Court said having sufficient exposure units is more important than the number of entities
  - Not enough exposure units looking only at those from affiliates – London Gold the only significant business operations
  - 3 jewelry stores, 2 key employees, and around 35 employees

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AVRAHAMI – POOL RISK DISTRIBUTION

- Taxpayers' risk distribution roughly 30% unrelated
  - *Harper Group* (9th Circuit) provided that 29% unrelated acceptable *but* large pool made up of thousands of policies

- Pan-American (pool) must be bona fide insurance
  - The Court stated that the Pan-American arrangement "looked suspiciously like a circular flow of funds" but arrangement is common in insurance industry
  - The Court found the terrorism premiums to be "grossly excessive" and questioned "one size fits all rates"
  - The Court found that it was unlikely that a covered loss would occur
  - The Court found that Pan-American would have trouble paying claims
  - Pan-American was compensated by fixed fee, rather than percent

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AVRAHAMI – COMMONLY ACCEPTED SENSE

- Lack of risk distribution is sufficient to determine not insurance; alternatively, not insurance in its commonly accepted sense

- The Court looked at five factors:
  1. Organized, operated, and regulated as an insurance company
  2. Adequate capitalization
  3. Valid and binding policies
  4. Reasonable premiums as the result of arm's length transaction
  5. Claims are paid

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AVRAHAMI – COMMONLY ACCEPTED SENSE

- Organized and regulated as an insurance company in St. Kitts; did not address whether needed to be regulated in the insureds' domicile
- Not operated as an insurance company – "left something to be desired"
  - Investments that "only an unthinking insurance company would make"
  - Illiquid, long-term loans to related parties (65% of Feedback's assets)
  - Failed to timely receive regulatory approval for loans
  - No claims from its 2007 inception until March 2013, two months after the insured's income tax audit commenced
  - Claims were dealt with on "an ad hoc basis"
  - Late claims approved
  - One claim that was paid was either potentially covered by commercial insurance or not a valid claim against Feedback

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AVRAHAMI – COMMONLY ACCEPTED SENSE

- Feedback was adequately capitalized
  - Prior case law found that minimum capitalization of domicile meant adequately capitalized, court accepted standard
- Policies should be valid and binding
  - The policies identified the insured, premium, and were signed
  - The Court found the policies to be unclear and contradictory and contained elements of both claim and occurrence policies
- Premiums "utterly unreasonable," aimed at a target and the actuary's explanations "often incomprehensible"
- Feedback met the requirement of paying claims

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AVRAHAMI – NOT ADDRESSED

- The number of affiliates needed to distribute risk
- Other insurance elements
  - Risk Shifting
  - Insurance Risk
- Government's other arguments
  - Economic substance
  - Substance-over-form
  - Step-transaction doctrines

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AVRAHAMI – NO PENALTIES

The Court did not impose a penalty on the taxpayers

- Taxpayers had reasonable cause to deduct the premium and acted in good faith
- Taxpayers had consulted an estate planning attorney
- Estate planning attorney not treated as a promoter despite that he was involved in establishing captive
  - He received a setup-fee, but the rest of the work was on an hourly basis
  - The taxpayers and attorney had prior relationship
- First time the Court addressed sections 162, 831(b) and 953(d) in the same case

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RESERVE MECHANICAL - OVERVIEW

- 66-page opinion by the United States Tax Court issued on June 18, 2018
  - Case involved section 501(c)(15), rather than 831(b)
- Court held that the taxpayers did not enter into a valid insurance transaction
  - No risk distribution
  - Not insurance in its commonly accepted sense
    - Not operated as an insurance company
    - One claim filed without any supporting documentation
    - Policies valid and binding, but "cookie cutter"
    - Rating spreadsheets used to calculate premiums did not include actual revenue
  - Premiums not otherwise deduction as a business expense
  - No penalties upheld against taxpayers
  - Foreign-domiciled captive lost its election under 953(d), and captive subject to the 30% tax imposed by section 881(a).
- Taxpayers appealing decision – 10th Circuit

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RESERVE MECHANICAL – FACTS FOUND

- Peak (Insured) in the business of distributing, servicing, repairing and manufacturing equipment used in underground mining and construction, RocQuest (Insured) owned real estate in Osburn and Hayden Lake, Idaho and Elko, Nevada
  - 13 employees
- Reserve incorporated and regulated in Anguilla
- Reserve issued policies directly, reinsured through PoolRe
  - Premiums allocated 81.5% to Reserve, 18.5% to PoolRe
  - Losses that PoolRe would pay were limited by attachment point and ceiling
    - 2008 and 2009 – PoolRe had no liability until claims exceeded 100% of total premiums and one of four attachment point scenarios occurred. The amount it would pay was further limited.
    - 2010 – PoolRe would pay claims exceeding 35% of total premiums. For claims above 35% threshold, PoolRe was liable to pay 50% and participation limited to 100% of total combined premiums
- PoolRe had almost no chance of sharing in losses based on structure – meant that no risk distribution
  - "Circular flow of funds"
- Second risk distribution mechanism – CreditRe – involved assuming risk from large pool of vehicle service contracts
  - Court found it suspect – taxpayers could not provide underlying documents

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Syzygy: Tax Court Determination

- Premiums not otherwise deductible as a business expense
- No penalties upheld against taxpayers
- Captive required to pay tax on premium income despite that it was not insurance
- Unreasonable premiums – actuary not required, but no calculations were provided – “will [sic] ass guess”

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Syzygy: Current Status

- TP Filed Motion to Vacate or Revise and Motion for Reconsideration – denied
- IRS filed a Motion to Clarify Order - pending

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Syzygy: Facts

- Highland Tank (Insured) manufactures above-ground and below-ground steel tanks, related companies
- 400 employees, 6 locations, revenue between $54-61 million
- Extensive commercial insurance
- Syzygy incorporated and regulated in Delaware

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Syzygy: Facts

Fronting carriers (Direct Writers) issued policies

- Layer 1 – first $250,000 of a single loss – reinsured by Syzygy
- Layer 2 – loss between $250,000 to $1 million – quota share pool of 40-50 unrelated companies
- Premiums allocated 49% to layer 1, 51% to layer 2
- Actuarial firm engaged by Alta (captive manager) estimated 70% of losses in layer 1, 30% in layer 2
- Syzygy's actual loss and loss adjustment expense of 0% for layer 1, 3% for layer 2

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Syzygy: Problem Areas

- Highland Tank did not file allowable claims
- Half of policies were for excess coverage – Court said premiums should have been less than noncaptive policies
- 7 day reporting period too short
- Syzygy owned life insurance polices – majority of assets
- Appeared to have a circular flow of funds

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Direct Writer Issue

- The Court analyzed the transaction at both the Direct Writer and the Captive
- IRS Agents are currently ignoring the Direct Writer
- IRS attorneys are looking at both the Direct Writer and the Captive
- Means that the Direct Writer/Insured transaction could be considered insurance and the section 162 deduction allowed
- Captive might not be considered an insurance company

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FUTURE OPINIONS

- *Caylor Land and Development v. Commissioner*, Dkt. No. 17204-13 (tried in May 2016 before Judge Holmes)
  - Artex
- *Wilson v. Commissioner,* Dkt. No. 26547-13 (tried in August 2016 before Judge Holmes)
  - Avrahami 2.0

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DOING CAPTIVES RIGHT

- Optics
- Driven by risk, not tax
- Policies should fit risk of operations
- Premiums determined independently, adjusted when claims experience available
  - No targets
  - Insured should prefer decreased premiums; Captive wants premiums sufficient to cover expected losses, provide profit provision
- Captive is not a piggy bank
  - Small amount of loans, loans should be collateralized
- Claims
- Adapt to caselaw

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Polling Question

Which cases did you find most interesting?

A. Rent-A-Center
B. RVI Guaranty
C. Avrahami
D. Reserve Mechanical
E. Syzygy

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39

Questions

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40