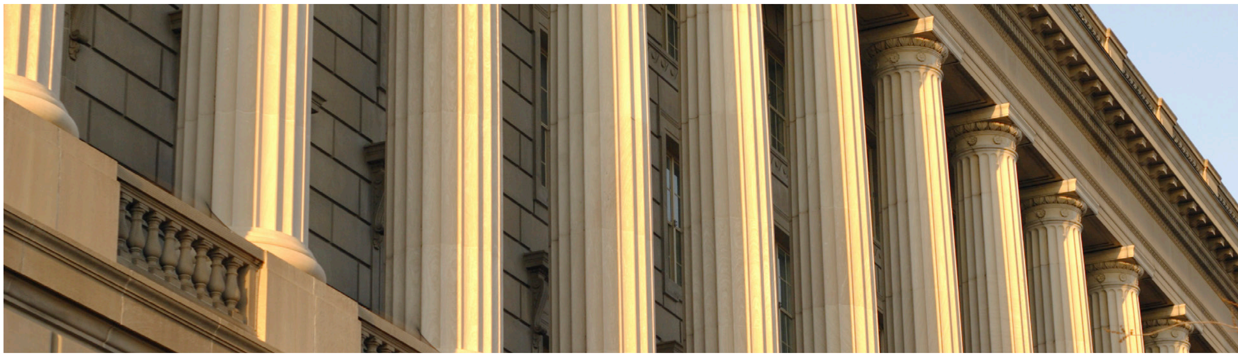
Rent-A-Center, Inc. v. Commissioner
Court rules that captive is an insurance company for tax purposes



On January 14, 2014, the Tax Court decided *Rent-A-Center, Inc. and Affiliated Subsidiaries v. Commissioner*, 142 T.C. No. 1 (2014) ("RAC Case" or the "Case"), involving a captive insurance arrangement that was challenged by the Internal Revenue Service ("IRS" or the "Service"). The Tax Court found a parental agreement between a captive and its parent could be present in a valid insurance arrangement for federal income tax purposes. The Case also dealt with the manner in which risk distribution is measured in determining the existence of insurance. The taxpayer in the RAC Case was a Texas resident and the case was heard in Texas.

The taxpayer, Rent-A-Center, Inc. ("RAC"), was the parent group of approximately 15 affiliated subsidiaries. RAC, through stores owned and operated by its subsidiaries, rented, sold, and delivered home electronics, furniture, and appliances. Partly in response to high fees paid to a commercial insurer, RAC formed Legacy, a Bermuda Class I insurer, in 2002 in an effort to lower costs and improve efficiency. From 2003 through 2007, RAC obtained unbundled worker's compensation, automobile, and general liability from Legacy up to a specified loss limit, and obtained coverage from Discover Re (an unrelated reinsurer) for losses in excess of those insured by Legacy.

RAC was a listed policyholder pursuant to the Legacy policies, but no premiums were attributable to RAC since it did not own stores, have employees or operate vehicles. Rather, RAC primarily operated through its subsidiaries to which it would recharge premium expenses. Approximately 60% of the risk insured by Legacy was concentrated in one of RAC's fifteen subsidiaries during the years at issue, and approximately 90% of the total risk was concentrated in four of its subsidiaries. Legacy received no premiums from unrelated entities from 2002 through 2007.

As part of the Bermuda regulatory requirements, Legacy was required to maintain a specified level of capital. To increase its regulatory capital, Legacy petitioned its regulator for permission to treat its deferred tax assets as general business assets. In 2003, such permission was granted, with the stipulation that Legacy's parent guarantee its liabilities up to $25 million. While the guarantee included Legacy's liabilities under the Bermuda Insurance Act, it did not guarantee Legacy's general liabilities to unrelated insurers.

The criteria various courts and the IRS have looked to in determining whether a captive arrangement qualifies as insurance for federal income tax purposes include: the captive company must be formed for a valid nontax reason; the transaction must meet risk shifting and risk distribution requirements; and it must resemble insurance in its "commonly accepted sense."

After finding that Legacy was formed for a valid business purpose, the Tax Court examined whether the transaction met the risk shifting and risk distribution requirements. In determining whether Legacy's policies shifted risk, the Tax Court focused on the arrangement's economic impact on RAC's subsidiaries, noting that the RAC subsidiaries' balance sheets would be unaffected in the event of an insured loss. (which some commentators refer to as the "balance sheet test") The Tax Court also found that the parental agreement between RAC and Legacy did not prevent the subsidiaries from shifting risk to the captive, noting that the parental guarantee did not impact the balance sheet test — the affiliate's balance sheets were protected whether or not the parental guarantee was in place. The Tax Court's decision in the RAC Case goes further than its decision in *Hospital Corp of America*, where the Tax Court found that the presence of a parental indemnity agreement that related to only a small portion of the captive's policies was not sufficient grounds to invalidate an otherwise bona fide insurance transaction. In that case, the court disallowed the premium deduction based on a lack of risk shifting, but limited the disallowance to the portion of the coverage that was potentially subject to the parental indemnity agreement. See *Hospital Corp. of America v. Comm'r*, T.C. Memo 997-482. The Tax Court distinguished several earlier cases (including *Malone & Hyde, v. Comm'r*, 62 F.3d 835 (6th Cir. 1995); *Carnation v Comm'r*, 71 T.C. 400; and *Kidde v. United States*, 40 Fed. Cl. 42 (1997)), which found that captive arrangements which involved parental guarantees did not constitute insurance for federal income tax purposes. In those cases, the captives were found to be undercapitalized and to have required guarantees at the behest of third-party insurers.

In finding that risk distribution was present, the Tax Court's analysis in the RAC case focused on the number of risks at issue, not the number of legal entities taking part in the insurance arrangement. Further, in its risk distribution analysis, the Tax Court did not express concern with the concentration of risk in each entity (as noted above, one entity had over the 60% of the total risk). As such, it did not find it necessary to rely on the safe harbor outlined in Rev. Rul. 2002-90, in which the IRS held that 12 subsidiaries, none with more than 15 percent of the total insured risks, were sufficient for finding a risk distribution.

The Service has never articulated its rationale for determining risk distribution based on the number of insureds. That position, however, stands in contrast to general insurance principles, under which risk distribution, based on the law of large numbers, focuses on the number of independent risks rather than the number of insureds.

In reaching its conclusion that risk distribution was present in the RAC Case, the Tax Court noted that Legacy insured three types of risk: workers compensation, automobile, and general liability. Additionally, the Tax Court noted that during 2003–2007, RAC's subsidiaries owned between 2,623 and 3,081 stores, had between 14,300 and 19,740 employees, operated between 7,143 and 8,027 insured vehicles, and operated stores in all 50 states. The Tax Court made no mention the number of legal entities insured as part of its analysis. The holding is significant because it provides further indication that the Tax Court views risk distribution based on general insurance principles, looking at the number of independent risks, rather than based on the IRS' "number of legal entities approach," as outlined in Rev. Rul. 2002-90. The RAC Case's rationale for risk distribution follows the approach found in *Gulf Oil*, where risk distribution was not dependent on the number of insured entities, and it was noted, "that a single insured can have sufficient unrelated risks to achieve adequate risk distribution." *Gulf Oil Corp. v. Comm'r*, 89 T.C. at 1010, 1026, (1987) (dictum), *rev'd in part on other grounds*, 914 F.2d 396 (3d Cir. 1990).

The Service has challenged numerous captive insurance arrangements involving one or a limited number of insureds — e.g., in cases involving protected cell companies and situations involving single member limited liability companies that are looked through for tax purposes — on risk distribution grounds. It is not clear whether the real concern of the Service in those situations is actually one of risk transfer, and not risk distribution. While such a position would be rebuttable as well, a risk distribution analysis, which by definition is based on large numbers of independent risks, does not require that the number of legal entities insured be taken into consideration.

As of the time of this writing, the IRS had not yet indicated whether it will revisit its approach in Rev. Rul. 2002-90, which focused on the number of insured entities (and the concentration of risk per entity) and focus instead on the number of independent risks in determining if a captive insurance arrangement has adequate risk distribution. The IRS has also not indicated whether the RAC Case could result in a different approach to parental guarantees and their role in invalidating captive insurance arrangements. RAC suggests that parental guarantees might not impact captive arrangements as long as the insured subsidiary's balance sheet is protected, and the captive is adequately capitalized.

Also, as of the time of this writing, the IRS had not yet not indicated whether it would acquiesce to the Tax Court's decision. We will keep abreast of developments in this area and will provide additional analyses, as events warrant, in the next edition of Taxing Times.

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