Alert

Tax Advice and Controversy Client Service Group

To: Our Clients and Friends

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Tax Court Holds Captive Insurance Arrangement Qualifies as Insurance

On October 29, the U.S. Tax Court held, in *Securitas Holdings, Inc. v. Commissioner*, T.C. Memo 2014-225, that a captive insurance arrangement qualified as an insurance arrangement and the insurance premiums paid were deductible for federal income tax purposes. In so holding, the Tax Court held both that (i) a parental guarantee by itself did not prevent the shifting of risk and (ii) the existence of risk distribution was determined by examining the number of independent risks and not the number of entities.

Securitas AB, a publicly traded Swedish company, owned, through a U.S. holding company, an affiliated group of U.S. corporations and a U.S. captive insurance subsidiary. The U.S. captive insurance subsidiary insured workers compensation, automobile, employment practice, general and fidelity risks of the U.S. corporations and then reinsured those risks with an Irish reinsurance company owned by Securitas. A majority of the premiums earned by the captive insurance subsidiary during one year were paid by a single entity. The performance of the captive insurance subsidiary was guaranteed by the U.S. holding company.

The IRS challenged this captive insurance arrangement arguing there was no risk shifting and no risk distribution. Risk shifting requires the economic risk of loss be shifted from the insured entity to the insurance company. The IRS argued the parental guarantee meant the economic risk of loss remained on the insured entities and not on the captive insurance subsidiary. The Tax Court, relying on its recent decision in *Rent-a-Center v. Commissioner*, held that a guarantee, by itself, is not enough to justify disregarding a captive insurance arrangement. Instead, the entire insurance arrangement (including any reinsurance arrangements) should be examined. In Securitas, there was adequate risk shifting because the insurance policies were reinsured and the performance of that reinsurer was not

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guaranteed. As a result, the U.S. subsidiaries shifted their economic risk of loss from to the U.S. captive insurance company, which then shifted the risk of loss to the Irish reinsurer.

The IRS also argued the arrangement did not have sufficient risk distribution to constitute insurance for federal income tax purposes. Risk distribution requires the insurance company to insure a large pool of independent risks in order to minimize the risk that a single claim will exceed the amount taken in as premiums. Traditionally, the IRS has looked to the number of entities that have been insured and not the number of independent risks. Relying on expert testimony, the Tax Court disagreed, holding that it is the number of exposures that creates risk distribution and not who owns the exposures.

The *Securitas* decision is favorable for taxpayers considering captive insurance arrangements because it supports the position that risk distribution can be achieved with only a few entities provided there are sufficient independent risks.

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