The Tax Court crystalizes the definition of risk

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Tax Court vs. IRS: a glance at varying views of risk distribution

Questions have been raised for years about whether risk distribution means several entities need to be insured or if multiple risk units need to be insured. The answer to these questions depends on whether the Tax Court or the IRS is defining risk distribution. This discussion below walks through the differences between the Tax Court and Internal Revenue Service (IRS) views of risk distribution and examines where these differences leave taxpayers.

The view of the courts

Neither the Internal Revenue Code nor the Treasury Regulations define the term "insurance." However, case law has developed a four-prong framework that must be present for insurance to exist:

1. The arrangement must involve the presence of an insurance risk.
2. There must be risk shifting.
3. There must be risk distribution.
4. The arrangement must be insurance in the commonly accepted sense. This article focuses on the third prong of the framework — risk distribution.

Initially, courts defined risk distribution by stating that risk distribution incorporates the statistical phenomenon known as the law of large numbers. Distributing risk allows the insurer to reduce the possibility that a single costly claim will exceed the amount taken in as premiums and set aside for the payment of such a claim. By assuming numerous independent risks that occur randomly over time, the insurer can reduce the volatility of the cost of insurance and predict the required premiums and investment income needed to satisfy claims.

Courts have recognized that risk distribution necessarily entails a pooling of premiums, so that a potential insured is not in significant part paying for its own risks. By diffusing the risks through a mass of separate risk-shifting contracts, the insurer casts its lot with the law of averages. The process of risk distribution, therefore, is the very essence of insurance.

Over time, the courts began changing their view, holding that risk distribution means a sufficient pool of independent risks rather than insuring several entities. In discussing the principles of risk shifting and risk distribution, the Tax Court in *Gulf Oil* stated, "In this instance 'unrelated risks' need not be those of unrelated parties; a single insured can have sufficient unrelated risks to achieve adequate risk distribution." A few years after *Gulf Oil*, the Tax Court in *Malone & Hyde* stated, "We also stated in *Gulf Oil*, that, in the right circumstances, a single insured can have sufficient unrelated risks to achieve adequate risk distribution."

In a 2014 decision, *Rent-A-Center*, the Tax Court looked to the number of statistically independent risks insured. Looking beyond the number of affiliates and subsidiaries, the court agreed that Rent-A-Center (RAC) met the risk distribution criteria as its affiliates and subsidiaries operated more than 2,500 rent-to-own stores throughout the United States, employed more than 14,000 individuals and owned more than 7,000 vehicles.

The Tax Court stated:

> Legacy insured three types of risk: workers' compensation, automobile, and general liability. During the years in issue, RAC's subsidiaries owned between 2,623 and 3,081 stores; had between 14,300 and 19,740 employees; and operated between 7,143 and 8,027 insured vehicles. RAC's subsidiaries operated stores in all 50 states, the District of Columbia, Puerto Rico, and Canada. RAC's subsidiaries had a sufficient number of statistically independent risks. Thus, by insuring RAC's subsidiaries, Legacy achieved adequate risk distribution.

Similar to *Rent-A-Center*, the Tax Court in 2014 also looked to the number of risks in *Securitas*. In *Securitas*, the court noted that an insurer distributes risk by pooling a "large enough collection of unrelated risks" that were not likely to be affected by the same event. Again, although only a small number of corporate entities were insured, the Tax Court stated that:

> As a result of the large number of employees, offices, vehicles and services provided by the US and non-US operating subsidiaries, [Securitas] was exposed to a large pool of statistically independent risk exposures. This does not change merely because multiple companies merge into one. The risks associated with those companies did not vanish once they fell under the same umbrella.

The Tax Court confirmed its previous holdings about risk distribution being a "sufficient number of statistically independent risks" in the 2015 *R.V.I. Guaranty Co., Ltd.* decision. Specifically, the Tax Court stated:

> Many insureds who pay premiums will not incur losses. Insuring many independent risks in return for numerous premiums thus serves to distribute risk, in effect spreading a portion of the insurer's potential liability among his insureds. See ***Black Hills Corp.***, 101 T.C. at 183; ***Harper Group***, 96 T.C. at 59; ***AMERCO***, 96 T.C. at 40–41. Distributing risk allows the insurer to reduce the possibility that a single costly claim will exceed the amount taken in as a premium and set aside for the payment of that claim.

In *R.V.I. Guaranty*, the court also noted that the "legal requirement for 'insurance' is that there be meaningful risk distribution; perfect independence of risks is not required."

The IRS did not appeal any of these three cases.

Following these cases, the Tax Court issued three additional decisions affirming its overall position on captives. The decisions, *Avrahami* (2017), *Reserve Mechanical* (2018) and *Syzygy* (2019), pertain to small insurance companies, e.g., Section 831(b) or Section 501(c)(15) companies. Although the decisions in these cases went for the government, the court cited its reasoning and decision principles in *Rent-A-Center*, *Securitas* and *R.V.I. Guaranty* as the basis for its decisions. On risk distribution, the Tax Court in *Avrahami* stated that:

> Since [the insurance company] was insuring only three affiliated entities in 2009 and four in 2010 … we will simply agree that when analyzing the number of related insured companies, [the insurance company] failed to adequately distribute risk.
>
> We also want to emphasize that it isn't just the number of brother-sister entities that one should look at in deciding whether an arrangement is distributing risk. It's even more important to figure out the number of independent risk exposures.

In *Reserve Mechanical*, the Tax Court stated that "[g]enerally, risk distribution occurs when the insurer pools a sufficiently large number of unrelated risks." The court did recognize in past cases, e.g., *Avrahami*, that "[the court] focused on both the number of insureds and the total number of independent risk exposures to determine whether an insurer distributed risk."

In *Syzygy*, the petitioners argued that Syzygy distributed risk by participating in various insurance pools. The Tax Court noted that before it can decide whether Syzygy distributed risk through the fronting carriers, it must address whether those carriers were bona fide insurance companies. The Tax Court then reviewed various facts and held that the fronting carriers were not bona fide insurance companies; therefore, Syzygy did not meet the risk distribution requirement.

The IRS view

Rev. Rul. 2002-90

The IRS issued its first ruling that focuses primarily on risk distribution in Rev. Rul. 2002-90. The ruling shows 12 subsidiaries insured by an insurance company. The 12 subsidiaries have a significant volume of independent, homogeneous risks. None of the subsidiaries have liability coverage for less than 5% nor more than 15% of the total risk insured by the insurance company. The narrow question presented is whether the common ownership of the 12 operating subsidiaries affects the conclusion that the arrangements are insurance for US federal income tax purposes. The IRS ruled that the arrangement between the insurance company and each of the 12 subsidiaries constitutes insurance for US federal income tax purposes.

Rev. Rul. 2005-40

In this ruling, the IRS examined four situations. The first situation involves a domestic corporation, X, operating a courier transport business covering a large portion of the United States. X owns and operates a large fleet of automotive vehicles representing a significant volume of independent, homogeneous risks. X enters into an insurance transaction with Y, an unrelated insurance company to insure the risk of loss arising out of X operating its fleet. Y does not insure any other entity or business except X.

The second situation includes the same facts as in the first situation except that, in addition to its arrangement with X, Y enters into an arrangement with another domestic corporation, Z, which is unrelated to X or Y, whereby in exchange for an agreed amount of premium Y insures Z's courier business. The amounts Y earns from its arrangements with Z constitute 10% of Y's total amounts earned during the year on a gross and a net basis. The arrangement with Z accounts for 10% of the total risks borne by Y.

The third situation includes the same facts as situation 1, except that X conducts its business through 12 limited liability companies (LLCs). The LLCs own and operate a large fleet of automotive vehicles representing a significant volume of independent, homogeneous risks. The LLCs are disregarded as entities separate from X. None of the LLCs account for less than 5%, or more than 15%, of the total risk assumed by Y, the insurance company from situation 1, under the agreements.

The fourth situation includes the facts that are the same as the third situation, except that each of the 12 LLCs elects to be classified as a corporation.

The IRS ruled that situations 1 through 3 lack the requisite risk distribution to constitute insurance, as all or 90% of the risk comes from a single entity. However, situation 4 did meet the requisite risk distribution to constitute insurance, as the 12 LLCs are classified as corporations for US federal income tax purposes.

Rev. Rul. 2009-26

The IRS added reinsurance to its definition of risk distribution in Rev. Rul. 2009-26. Rev. Rul. 2009-26 examines two factual situations. In situation 1, Y and Z are regulated as insurance companies. Y entered into a contract with Z, under which Y would pay Z 90% of all the premiums that Y received from its insurance contracts in the commercial multiple-peril line of business. In exchange, Z agreed to indemnify Y for 90% of all the losses under those contracts. The contract is sometimes referred to as indemnity reinsurance. Insurance contracts Y entered with 10,000 unrelated policyholders were subject to the contract between Y and Z. The contract with Y was Z's only business during the year.

Situation 2 has the same facts as situation 1, except that the contract between Y and Z covered only the risks of X, a policyholder of Y unrelated to Z. In addition, Z assumed risks of policyholders unrelated to X but in the same line of business through contracts with other insurance companies. Had Z directly assumed these risks by entering into contracts with each of the original policyholders, including X, those contracts would have qualified as insurance contracts.

Even though the agreement was Z's only business during the year, the IRS ruled in situation 1 that the requirement of risk distribution was still met from the standpoint of Z as to each of the original 10,000 policyholders. In situation 2, the IRS ruled that risk distribution was met from the standpoint of Z as to each original policyholder, as there were several insurance companies ceding business to Z. In situations 1 and 2, the IRS applied a look-through concept, i.e., a reinsurer could look to the policyholders of a fronting company to determine if risk distribution should be met.

Where do these differing views leave taxpayers?

In general, a taxpayer with 12 or more subsidiaries and a sufficient pool of independent risks insured should meet the IRS view (assuming the taxpayer meets other parameters mentioned in Rev. Rul. 2002-90) and the courts' view of risk distribution. For structures with less than 12 subsidiaries insured, the captive can meet the Tax Court's definition of risk distribution in *Rent-A-Center*, *Securitas* and *R.V.I. Guaranty*, if the taxpayer's insurance company has a sufficient pool of independent risks insured.

As this article addresses only general situations and guidance, each individual captive insurance structure should be reviewed based on its individual facts and circumstances.

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