Commentary No. 5 by Capstone Associated Services, Ltd.

Does Captive Insurance Exist After the *Reserve* Decision?

Tax Court Continues to Apply Erroneous Legal Analysis to Pooling Arrangements in *Syzygy* Case

On April 10, 2019, the Tax Court issued its most recent decision regarding a captive insurance arrangement in *Syzygy Ins. Co. v. Commissioner*, T.C. Memo 2019-34. The Tax Court sustained the IRS's income tax deficiencies against the insured businesses based on disallowed premium deductions while at the same time taxing those identical dollars paid for premiums as income to the captive.

Syzygy was a section 831(b) captive insurance company that participated in a "pooling arrangement," whereby it reinsured risks of other unrelated captive participants in an effort to achieve risk distribution. In reviewing Syzygy's pooling arrangement, the Tax Court followed the same legal analysis that it first established in *Avrahami* (2017) and later followed in *Reserve* (2018). Capstone believes that the Tax Court committed a critical, reversible error in not following decades of well-established case law in this area.

Avrahami was not appealed. *Reserve* is on appeal to the U.S. Court of Appeals for the Tenth Circuit (see discussion below). It is too early in the process to know whether *Syzygy* will be appealed.
The *Syzygy* decision makes clear that the Tax Court continues to follow the same legal analysis first established in *Avrahami* that we believe to be flawed. That being said, there were a number of unfavorable facts present in *Syzygy* that weighed in favor of an IRS victory. These facts include the following:

- The Tax Court concluded that Syzygy's premiums were not actuarially determined in that, per the Tax Court, no actuarial model or comparison with similar publicly available policies was used to support its premium calculations. However, both an actuarial expert and actuaries contracted by Syzygy's Delaware regulator reviewed the premium pricing, as paid, to be reasonable. This otherwise surprising result is consistent with the Tax Court's choosing facts supportive of its opinion in other captive cases and brushing aside other facts.

- Although a number of insured losses would have been covered under Syzygy's deductible reimbursement policy, claims were not submitted by the insureds.

- Despite the fact that a captive's policies can change over time, the Tax Court criticized Syzygy for not providing one of the original coverages contemplated by the insureds as a reason for forming the captive.

- The documentation of Syzygy's policies was ambiguous, and its policies were issued late, in fact after the coverage period had expired.

- The captive manager was fired by one of Syzygy's two owners/officers because the captive manager expressed a concern that premiums for the captive coverages should be reduced.

- The pricing rate on line for commercial coverages purchased by the insured was about 1% and Syzygy's captive coverages were about 6%, although the captive coverages were all issued on an

excess basis. That is, the Tax Court took issue with the premium pricing despite the testimony of an actuarial expert in support of the premium pricing.

- Approximately 50% of Syzygy's assets were invested in split-dollar life insurance, which was highly illiquid and could not be easily accessed to satisfy claims.

An additional concern introduced by the Tax Court in *Syzygy* was the effect of "double taxing" the transaction between the Delaware captive and its affiliated insureds. The Tax Court "whipsawed" the taxpayers by holding that (1) the premiums paid by the insureds to the captive were not deductible while (2) those same premiums were treated as taxable income received by the captive. This result is also contrary to prior case law and IRS revenue rulings.

The facts of the *Reserve* case are distinguishable from the unfavorable facts in *Syzygy* listed above. The appeal of *Reserve* to the Tenth Circuit is currently in the briefing stage, with Reserve's opening brief expected to be filed this summer. *Reserve* will be the first captive insurance case decided in any U.S. Court of Appeals since the *UPS* case, which was decided by the Eleventh Circuit in 2001 in favor of the taxpayer. Capstone believes that the post-2016 Tax Court decisions have significantly departed from established law in the captive area.

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