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Court Shouldn’t Upend Insurance Norms for Captives, Groups Say

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Captive insurance advocates urged the Tenth Circuit to heed well-established insurance principles, which they say the Tax Court misconstrued in determining whether arrangements qualify as insurance for federal income tax purposes.

The Tax Court’s 2018 decision (T.C. Memo. 2018-86) misinterpreted several elements in determining whether Reserve Mechanical Corp., an insurer wholly owned by its insureds, qualifies as an insurance company under the tax code, according to 10 captive insurance trade organizations and the Self Insurance Institute of America Inc.

“Regardless of whether the Court affirms or reverses the decision . . . on other grounds or case-specific evidence, it should take care that nothing in its opinion suggests new limits on widely accepted and long-standing principles of insurance and tax law,” the industry groups said in a February 27 amici curiae brief.

The industry groups specifically ask the Tenth Circuit to confirm that prior loss history isn’t a prerequisite for a valid insurance arrangement; that insurance policies don’t need to be “individually manuscripted and negotiated”; and that arrangements don’t fail risk distribution tests “merely because the insurance premiums paid into the pool were identical in amount to the dollars ceded to ultimate reinsurers.”

By imposing those requirements, the Tax Court contradicts “both domestic and international insurance market practice, and established insurance doctrine and law, all of which have been previously accepted by the IRS,” the brief says.

The Tax Court found that Reserve failed to satisfy two of four case law criteria — risk distribution and operating the way a normal insurance company would — for determining whether arrangements constitute insurance eligible for tax benefits.

The court therefore held that the captive insurer doesn’t qualify as a tax-exempt insurance company under section 501(c)(15) and is ineligible to elect to be treated as a domestic corporation under section 953(d).

Small captive companies may also qualify as an insurance company if they satisfy the requirements under section 831(b).

In *Reserve Mechanical Corp. v. Commissioner*, however, the Tax Court misconstrued several elements of what constitutes valid insurance for a captive in reaching its conclusions, so its decision "was in error and must be reversed or modified," according to the industry groups.

In its February 21 opening appellant brief, Reserve emphasized the significance of this case, saying that it will be the first circuit court decision to analyze a "captive insurer's risk distribution through reinsurance arrangements and participation in a risk pool."

Circular Flow Disputed

Reserve argued that it effectively distributed risk because more than 30 percent of its gross premiums were derived from insurance unrelated to the captive insurance arrangement with its direct insureds, citing *Harper Group v. Commissioner*, 96 T.C. 45 (1991).

The company said the risk distribution was achieved through a quota share risk-pooling arrangement with PoolRe Insurance Corp. and coinsurance contracts with Credit Reassurance Corp. Ltd.

But the Tax Court said, "Before we can determine whether Reserve effectively distributed risk through these agreements, we must determine whether PoolRe was a bona fide insurance company."

The court cited nine factors it has considered for a valid insurance company with one negative element being a circular flow of funds.

Because Reserve "would receive payments from PoolRe in exactly the same amount as the payments that PoolRe was entitled to receive from [Reserve's insureds] . . . 'this arrangement looks suspiciously like a circular flow of funds,'" Judge Kathleen Kerrigan concluded, citing the court's seminal microcaptive case — *Avrahami v. Commissioner*, 149 T.C. 144 (2017).

However, the industry groups' brief argues that the Tax Court "simply misunderstood the common insurance transaction of risk pooling [and] . . . . erred in finding that risk pooling was inherently suspect." That led the court to mischaracterize the arrangement as a circular flow of funds, according to the groups.

The groups' brief explains that each pool participant receives the same amount of risk and premium they put into the pool, but that the transaction "materially changes its participants' economic position by mixing the risks they insure."

Risk pools "have long been recognized as valid and effective means of facilitating risk distribution" that are common in commercial and captive insurance, so having the amounts of insurance paid into the pool equal to the amounts ceded to ultimate reinsurers shouldn't negate an otherwise valid risk-distribution arrangement, the industry groups said.

Loss History 'Absurd'

Another factor the court assessed in determining whether PoolRe was a viable insurance company was whether it faced actual and insurable risk.

Kerrigan concluded that PoolRe was "far removed from any actual risk" concerning Reserve's insureds because those businesses had no history of losses — that is, "before the tax years in issue they never suffered any losses that would even come close to triggering" the applicable coverage in the agreements.

"Requiring a policyholder to have suffered a previous similar loss before it will recognize a policy as being *bona fide* insurance is a requirement which does not exist in insurance law and which upends centuries of insurance practice and legal reasoning," according to the industry groups' brief.

"This flawed analysis puts the taxpayer in the absurd position of only being able to buy insurance after it has suffered a loss," the brief says, adding that the court should have instead "applied traditional insurance principles and considered whether [the policies] provide indemnity for a fortuitous risk."

Applying the Tax Court's analysis would mean that "a fire insurance policy would be inappropriate without a prior fire loss," the industry groups said. Similarly, they said a cyber policy would require a prior "ransomware" event, and a coastal windstorm policy would require that the property had already been destroyed by a hurricane to qualify as valid insurance.

"These examples underscore the impropriety of substituting the Tax Court's requirement of a prior loss for the long-standing requirement of fortuitous risk of future loss," according to the brief, which emphasized that it's "the potential for future loss, not the presence or absence of prior loss, which ultimately characterizes insurance."

Standard Is Standard

The Tax Court assessed, in the alternative, whether Reserve's transactions constituted "insurance in the commonly accepted sense."

Again, the court applied a multifactor test and evaluated, among other things, whether Reserve's policies were valid and binding. Kerrigan found positive and negative factors and concluded overall that the results were neutral for that element.

But what alarmed the industry groups was the court's criticism of Reserve's use of standardized documents — referring to them as "cookie-cutter" policies. Those comments could be construed "to require custom written — i.e., manuscripted — policies in order for the Tax Court to conclude that the policies were valid and binding," according to the brief.

The industry groups point out that courts have long recognized the efficiencies that standard contracts bring to the commercial insurance market, noting that captive insurers and captive managers have found the same benefits from using contracts with common basic provisions.

Thus, the Tax Court erred in concluding that standard policies “do not constitute insurance in the commonly accepted sense, when in fact, the commercial insurance market operates just this way,” the groups said.

The petitioners in *Reserve Mechanical Corp. v. Commissioner*, No. 18-9011 (10th Cir. 2020), are represented by attorneys from Foley & Lardner LLP and the Feldman Law Firm LLP.