BAUKNIGHT PIETRAS & STORMER, P.A.
Tax | Assurance | Consulting

1517 Gervais Street
PO Box 1330
Columbia, SC 29202
T 803-771-8943
F 803-771-8958

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Insurance Update: A New Twist on Risk

- R. Benjamin Glenn, CPA

A corporate group (Securitas Holdings) was allowed a deduction for the insurance premiums paid under a captive insurance arrangement. The arrangement shifted risk from the corporate group to the captive insurance company and ultimately to the captive reinsurance company in Ireland. Further, the captive arrangement also distributed risk by insuring a large pool of differing risks. Lastly, the arrangement did constitute insurance in the commonly accepted sense. Accordingly, the court found that the captive arrangement was insurance for Federal tax purposes.

On the heels of the Rent-A-Center decision, which called into question prior IRS Revenue Rulings 2005-40 and 2002-90, Securitas Holdings, Inc. ("SHI") scored a major victory via a recent tax court memoranda (T.C. Memo 2014-225). The court, in issuing a memorandum opinion in favor of SHI, found in part that a parental guarantee is not the death knell it was once thought to be and more importantly that risk distribution can be attained through high volumes of independent risks rather than number of policyholders. Both cases (SHI and Rent-A-Center) stir echoes of the ultimate defeat of the "economic family theory", a theory propagated by the IRS for decades until numerous court defeats forced them to famously concede in IRS Revenue Ruling 2001-31. A similar pattern could play out here with regards to parental guarantees and the concept of risk distribution. Captive owners should be encouraged by the conclusion in both cases but at the same time proceed with caution.

The Facts

The case involved Securitas Holdings, Inc. and premiums paid to their captive insurance company Protectors Insurance Co. of Vermont ("Protectors") which were ultimately ceded to Securitas Group Reinsurance Ltd., "SGRL") an Irish reinsurance company and subsidiary of Securitas. The US Tax Court found that the captive arrangement contained satisfactory insurable risks, risk shifting, risk distribution and insurance in the commonly accepted sense and therefore was insurance for Federal income tax purposes.

SHI purchased Protectors in 2000 and in 2003 they became a wholly owned subsidiary of SHI. Protectors wrote policies covering the risks (workers compensation, automobile, employment practice, general, and fidelity liability risks) of the U.S. subsidiaries of SHI. In order to preserve the tax-exempt status of a related tax-exempt insurance company, SHI guaranteed the policies issued by Protectors for 2003 and 2004.

Pinkerton's, Inc. and Securitas Security Services USA, Inc., subsidiaries of SHI, both served as the common paymasters for the insurance premiums due and claims paid for themselves and other SHI Group subsidiaries. The two companies recorded premiums due and claims paid as accounts payable and accounts receivable, respectively. The accounts were netted and paid to Protectors who then paid amounts due to SGRL.

The IRS asserted that the payments made under the captive arrangement did not constitute insurance for Federal income tax purposes for 2003 and 2004 and assessed a total of $29 million in deficiencies.

The Decision

The court referenced the decision in Rent-A-Center, Inc. v. Commissioner, among others, to affirm that the captive arrangement was indeed insurance. On the issue of risk shifting the court found that the use of journal entries to track the premiums due and claims paid had no effect on risk shifting. Also the existence of the guarantee did not prevent risk shifting especially since the guarantee was never utilized. The court also noted that risk distribution was met based on the high volume of employees and vehicles that were insured not on the number of insured entities, a position that runs counter to IRS Revenue Rulings 2005-40 and 2002-90.

The Implications

The opinion implies, for example, that a captive insurance program which insures deductible reimbursement policies of a construction company which has hundreds of ongoing projects nationwide could obtain risk distribution based on the law of large numbers applying to the independent risk represented by each individual project. This is a positive development for captive insurance programs whose facts do not follow the hypotheticals contained in IRS Revenue Rulings 2005-40 and 2002-90. If such programs were encouraged by the Rent-A-Center decision they should be even more so by the T.C. Memoranda issued under Securitas, Inc.

R. Benjamin (Ben) Glenn, CPA, is the lead manager on the BP&S Captive Insurance Team and is responsible for all tax compliance, research and consulting for the Firm's clients in the captive insurance industry. With 14 years in public accounting, Ben provides tax compliance and planning services for individuals, corporations and partnerships.

R. Benjamin Glenn, CPA
803.771.8943
bglenn@bpscpas.com