CAPTIVE INSURANCE COMPANY REPORTS

Evaluating 831(b) Captives in the Wake of *Rent-A-Center*

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June 2014

Editor's Note: Below is the first article by new authors for *CICR,* **Andrew Rennick** and **Jeffrey Simpson,** partners of the law firm of Gordon, Fournaris & Mammarella, PA. They give us another way to see the consequences of the *Rent-A-Center* ruling that may open some new doors. Mr. Rennick can be reached at ARennick@gfmlaw.com.

Of note in the recent opinion of the US Tax Court in *Rent-A-Center, Inc., and Affiliated Subsidiaries v. Commissioner of Internal Revenue,* 2014 U.S. Tax Ct. LEXIS 1 (T.C. Jan. 14, 2014), is a rebuke of the Internal Revenue Service (IRS) attempt to compare the *Rent-A-Center* captive program to a commercial insurance program. The IRS presented an expert witness who concluded that the captive arrangement was a sham, emphasizing that the captive's premium-to-surplus ratio was significantly higher than that of a commercial program, and that the captive "did not involve risk shifting … comparable to that provided by a commercial insurance program." Explaining that a captive's premium-to-surplus ratio could be expected to be higher than that of a commercial insurer, the court termed the comparison "not instructive." Turning to the expert's risk-shifting argument, the court "decline[d] his invitation to premise our holding on a specious comparability analysis." Instead, the court asked a more basic question—was the risk shifted or not?—and answered in the affirmative.

The court's insistence on analyzing captives on their own terms is helpful in light of an anticipated increase in IRS scrutiny of captive insurance arrangements. Over the last 6 months, a series of articles have reported on this increased scrutiny and have taken particular notice of the small captive electing taxation under IRC 831(b). Just as captive insurance arrangements in general suffer from "specious comparisons" with their commercial counterparts, the 831(b) captive bears the brunt of attempts by its more established captive brethren to distinguish itself as somehow more legitimate.

The 831(b) captive's reputational challenge is illustrated by a quote from an attorney in the March 2014 edition of *CICR,* who worried that "our 'pure of heart' entreaties could be tainted by 831(b)s and other more mercenary goals of some subsectors of our industry." (See Finally: A Rent-A-Center Decision.) But if, as articulated by the *Rent-A-Center* court, the measure of a captive's legitimacy is something other than its adherence to the standards and practices of commercial insurers, then it is worth having a foundational conversation about the nature and purpose of the 831(b) captive.

We believe that the 831(b) captive is best understood as occupying a locus of several important business concerns. It is no accident that the interest in 831(b) captives has coincided with the growth of enterprise risk management (ERM)—a dynamic and holistic approach to risk management that expands an organization's risk focus beyond traditional operational and hazard risks, and integrates risk management with the entire organization's strategy. What ERM teaches is that decisions regarding the organization's mix of risk transfer and retention, short- and long-term financing, cash flow management, business succession, and wealth accumulation do not exist in respective vacuums. Nor does tax planning. It is worth remembering that tax laws are more than a means of collecting revenue—they encourage economic behavior that legislatures favor and discourage behavior that legislatures disfavor. The 831(b) captive should therefore be conceptualized holistically—as a vehicle encouraged by the federal tax code to manage the enterprise risks of a business organization.

An "Enterprise Risk Captive"

With these considerations in mind, captive professionals working in the 831(b) space should view *Rent-A-Center* as an invitation to ask ourselves basic questions about the enterprise risk management function of the small captive insurance company and its role within the business enterprise:

- What are appropriate risks to insure through such a captive?
- What should the policies for those risks look like, and how might they need to differ from traditional forms in order to achieve the captive's unique objectives?
- What sort of reinsurance arrangements might be necessary or advisable to reduce volatility and create predictable cash flows?
- Given the types of insurance and reinsurance arrangements that are selected, what sort of claims experience and loss ratios should be expected?
- How should premium-to-surplus ratios be promulgated?
- How should investment strategies be crafted to match liquidity requirements?

Only when we examine the 831(b) captive (or to use a more precise name, the "enterprise risk captive") on its own terms, with a unique set of goals, will we be able to conduct a meaningful analysis of the best practices to reach those goals. Our hope is that, in addition to developing those best practices, this examination will help define the standards use in, and perhaps shape the language of, responses to the challenges that await the enterprise risk captive.

Reproduced from the June 2014 issue of *Captive Insurance Company Reports*.