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IRS LOSES THIRD CAPTIVE CASE IN FAVOR OF TAXPAYERS

On September 21st, 2015 the U.S. Tax Court ruled in favor of an insurance company, ***R.V.I. Guaranty Co., Ltd. & Subsidiaries v. Commissioner***. It is the third major captive insurance case ruled in favor of taxpayers within the last two years and it comes on the heels of two major IRS tax court losses in the captive arena, ***Rent-A-Center, Inc. & Subs. V Commissioner (January 14, 2014)***, and ***Securitas Holdings, Inc. v. Commissioner(October 29,2014)***.

The IRS has been aggressive recently, increasing audits of captive insurance companies despite congressional direction as to their validity. The IRS audit of captives is certainly nothing new; from 1970s until 2001, the IRS challenged nearly every captive program. It was only due to its many defeats in court that in 2001 it abandoned its economic family doctrine challenge to captives.

Properly designed and managed, 831(b) electing captives are valid business tools; however, some captive owners may be required to defend their structure at appeals or tax court, as the IRS continues taking unsupportable positions to the contrary. It is estimated that currently 80% of Fortune 500 companies utilize some form of a captive insurance solution.

The court stated unequivocally that, when it comes to insuring low-frequency but high-severity risks, frequency of claims and low claims ratios have very little probative value in determining the legitimacy of the insurance arrangement. Neither was the IRS "plausibility metric" accepted by the courts, which explicitly contradicts one of the IRS theories of attack against captive "risk pools" – that low claims ratios or low claims frequency is de facto evidence of a sham.

The IRS argued that RVI did not insure "pure risk" but rather only "speculative risks" (sometimes called "business risks" by the IRS) who the IRS argued was not "real insurance". This is consistent with the IRS position in its 2015 "Dirty Dozen" listing where the Service cautioned taxpayers to be careful of captive insurance companies that issue "policies to cover ordinary business risks" as opposed, presumably, to those that cover pure risks. The court concluded:

In any event, we find respondent's (IRS) attempt to distinguish between a "pure risk" and a "speculative risk" in this setting as essentially "metaphysical" in nature.

When the court calls your argument "metaphysical", you can be sure that you're going to lose, and lose the IRS did, stating further:

(The IRS's) efforts to split hairs by disentangling the causes of "loss" are philosophically interesting. But we do not think they carry much weight in determining whether the RVI policies constitute "insurance" for Federal income tax purposes.

The court concluded:

The legal requirement for "insurance" is that meaningful risk distribution exists; perfect independence of risk is not required. We have no difficulty concluding, as respondent's (IRS) expert Mr. Cook ultimately did, that the RVI policies accomplish sufficient risk distribution to be classified as "insurance" for Federal tax purposes.


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The court stuck a major blow at the heart of the IRS recent arguments, often launched at captive risk pools, which is that true insurance arrangements only pool "homogeneous" risks. In the court's mind, a pooling of unrelated risk is sufficient to achieve risk distribution.

The RVI Guaranty Case is a significant win for taxpayers, captive insurance companies and business that are served by non-traditional risk management approaches. The ruling by the court was broadly worded and completely undermines the IRS' attempts to draw an artificial distinction between "insurance" risks and "business" or "speculative" risks. The ruling also bolstered the position of many re-insurance (or risk distribution) pools commonly employed by small captive insurance companies to meet the risk distributions requirements. It is clear to readers of the case, that insurance policies and companies will generally be respected by the Tax Court.

For questions related to your captive insurance company, please call the specialist at RJI CPA's.