KPMG

TaxNewsFlash

United States

No. 2022-150
May 17, 2022

Tenth Circuit: Taxpayer did not qualify as small insurance company; Tax Court decision affirmed

The U.S. Court of Appeals for the Tenth Circuit affirmed the U.S. Tax Court's decision upholding an IRS determination that the taxpayer did not qualify for an exemption from income tax as a small insurance company and that the purported insurance premiums it received must therefore be taxed at a 30% rate under section 881(a). In addition, the Tenth Circuit also held that premium payments taxpayer received are not capital contributions.

The case is: *Reserve Mechanical Corp. v. Commissioner*, No. 81-9011 (10th Cir. May 13, 2022). Read the Tenth Circuit's **decision** [PDF 601 KB]

Background

From 2008-2010, the taxpayer issued several insurance policies to a corporation that was indirectly wholly owned by two individuals who also indirectly wholly owned the taxpayer. Before these policies were issued, the insured corporation had limited its insurance coverage to commercial policies that cost about $100,000 a year. The insured corporation maintained those policies but also paid the taxpayer more than $400,000 a year for the supplemental insurance obtained through the new policies. The relationship between such a taxpayer and the insured corporation is often termed "captive" insurance.

The taxpayer then engaged a third-party captive insurance consultant to assist it in assuring that the taxpayer qualified as an insurance company for federal tax purposes. The consultant ostensibly created diversification of risks in two ways, which together accounted for about 30% of the "premiums" received by the taxpayer. First, using a corporation it managed, the consultant arranged for 50-some captives under its management to, in essence, be liable on reinsurance policies issued to each other. Second, the consultant purportedly arranged for each captive to reinsure a small percentage of risk that same corporation assumed from coinsuring thousands of vehicle-service contracts with another insurance company.

The IRS disputed that the taxpayer was tax exempt under section 501(c)(15) (which exempts insurance companies from income taxation under section 501(a) if they receive no more than $600,000 a year in premiums) on the grounds that the taxpayer's "purported insurance and/or reinsurance transactions lack[ed] economic substance," and that the money it had received was "not paid to an insurance company and . . . [was] not paid for insurance." As a result, the IRS classified the taxpayer's income as fixed or determinable annual

periodical (FDAP) income received from sources within the United States, but not effectively connected with the conduct of a trade or business within the United States, subject to a 30% tax rate under section 881(a).

The taxpayer contested the assessment, arguing that it was in fact an insurance company and that if it was not, the purported premiums it received were a nontaxable capital contribution to the company. The case was tried in the U.S. Tax Court, which agreed with the position of the IRS. The taxpayer then appealed.

Tenth Circuit

The Tenth Circuit held that the record supported the Tax Court's decision that the taxpayer was not engaged in the business of insurance.

The appeals court observed that the Tax Court had two grounds for deciding that the taxpayer was not an insurance company. First, it determined that the taxpayer had not adequately distributed risk among a large number of independent insureds—a hallmark of any true insurance company. Virtually all the insured risk was that of one insured, a company that had the same ownership as the taxpayer itself. To appear to distribute risk, the taxpayer entered into an insurance pool with other purported insurance companies, each owned by an affiliate of its insured, but the arrangement lacked substance and the pool itself did not distribute risk.

Second, the Tax Court determined that the policies issued by the taxpayer were not insurance in the commonly accepted sense. For example, the premiums were not the result of arm's length transactions and were not reasonable, and the taxpayer was not operated in the way legitimate insurance companies operate.

In addition, the Tenth Circuit rejected the taxpayer's argument that if it was not an insurance company, the premiums it received must be treated as nontaxable capital contributions. Instead, the appeals court agreed with the Tax Court that the payments were FDAP (i.e., fixed or determinable annual or periodical gains, profits and income that are received from sources within the United States, but are not effectively connected to a trade or business). Under section 881(a), FDAP is subject to a 30% tax rate.

The Tenth Circuit further held that the payments taxpayer received were not capital contributions because there was no intent from the payor to treat them as capital contributions. See *United States v. Chi., Burlington & Quincy R.R. Co.,* 412 U.S. 401, 411 (1973).

KPMG observation

The determination of whether an entity is an insurance company for federal tax purposes is based on facts and circumstances. Thus, it is important to determine that the contracts issued by an entity that purports to be an insurance company meet the common law requirements of insurable risk, insurance in the commonly accepted sense, risk shifting and risk distribution. This is especially critical for taxpayers that elect small insurance company treatment under section 831(b).

In support of their argument that payments received by taxpayer were capital contributions, the taxpayer cited Rev. Rul. 2005-40, 2005-2 C.B. 4 (2005). This ruling provides that if an entity does qualify as an insurance company for federal tax purposes, the amounts received could be considered a deposit arrangement, a loan, a contribution of capital, an indemnity arrangement or something else. This list is clearly not exclusive, and the payment would have to have the appropriate characteristics of a deposit, loan, capital contribution, etc. A determination of treatment for payments that are not insurance premiums requires a facts-and-circumstances review.

For more information contact a tax professional with KPMG's Washington National Tax:

Sheryl Flum | +1 (202) 533-3394 | sflum@kpmg.com

Lori Robbins | +1 (202) 533-3491 | lorirobbins@kpmg.com

kpmg.com/socialmedia