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Syzygy Insurance – Another Microcaptive Does Not Meet the Test

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In *Syzygy Ins. Co. v. Comm'r of Internal Revenue, 117 T.C.M. (CCH) 1165 (T.C. 2019)*, Syzygy was a microcaptive insurance company established by the Highland Tank companies. Highland was closely held by the Jacob family.

Syzygy was organized with assistance by Alta. Syzygy and Highland participated in Alta's captive insurance program. Participants consisted of companies purchasing captive insurance and their related captive insurers. Typically, participants did not directly purchase policies from their captive insurers but from fronting carriers related to Alta.

Microcaptive Election. Insurance companies are generally taxed on income like other corporations. However, under 26 U.S.C.A. § 831(b) (West) there is an alternative for small insurance companies. If net written premiums or direct written premiums does not exceed $1.2 million (increased to $2.2 million in 2015), the company can elect to be taxed under 26 U.S.C.A. § 831(b). If so, the company is only taxed on investment income, and not on earned premiums.

Such a company must transact in "insurance." Businesses can deduct premium payments only if they are truly payments for insurance.

Circular Flow of Funds. Highland paid fronting carriers $1,373,500 of gross premiums and the fronting carriers ceded $1,319,055 of those insurance premiums to Syzygy. The court found that while this was not quite a "complete loop" this looked suspiciously like a circular flow of funds.

Arm's-Length Contract. Highland captive premiums had an average rate-on-line ("an insurance policy's premium divided by the occurrence limit.") that was five times greater than its commercial non-captive policies. The facts indicated the premium for the captive policies should have had a lower rate-on-line.

The court concluded that the higher average rate-on-line, coupled with the policies' restrictive reporting provisions, and no refund of premium on cancellation indicated that the policies were not arms-length contracts. The court also noted an email from Highland to Alta terminating the program because of a *decrease* in premiums.

Actuarially Determined Premiums. The taxpayers had an insurance underwriting consultant. However, the consultant described one of his steps in the pricing process as a "wild ass guess." Also, the report showed no calculations of premium prices.

There was also a problem with the allocation of premiums between layer 1 (the first $250,000 of loss) and layer 2 (the next $750,000 of loss). The premium was allocated 51/49% between these layers. Evidence showed much more premium should have been allocated to layer 1 and less to layer 2.

Risk Distribution. The evidence indicated that the two fronting companies were not bona fide insurance companies, which in turn meant that they did not issue insurance policies. Therefore, Syzygy's reinsurance of those policies did not distribute risk. As a result, Syzygy did not accomplish sufficient risk distribution through those fronting carriers.

Insurance in the Commonly Accepted Sense. The court considered whether the transactions were insurance transactions. The court considers factors including whether the company was organized, operated and regulated as an insurance company, whether it was adequately capitalized, whether the policies were valid and binding, if the premiums were reasonable and the result of arms-length transactions and whether claims were paid.

The court found that capitalization was adequate, inasmuch as the state department of insurance approved capitalization.

Highland did not submit a claim to a fronting carrier or Syzygy. There were about $100,000 worth of deductibles under other policies that were covered under a deductible reimbursement policy in the captive program, but no claims were submitted. Highland had no claims process for captive claims. Syzygy did pay one claim, but it was unclear whether it was covered, and Syzygy did not investigate coverage before paying.

Syzygy's investment choices are troubling. Fifty percent of its assets were life insurance policies on the two principals. Syzygy could not access the cash value, borrow against, surrender or cancel the policies, nor unilaterally terminate the agreements. The court held that an insurer would not invest more than 50% of its assets in an investment that it could not access to pay claims.

Valid and Binding Policies. The courts found that neither Syzygy nor the fronting carriers timely issued the policies to Highland. Some policies were not issued until after the policies expired.

There are ambiguities in the policies. It was unclear whether the policies insured only the Highland parent entity, or all of the related entities; and what policy deductibles were covered by the deductible reimbursement policy.

The court concluded that "Although Syzygy was organized and regulated as an insurance company, met Delaware's minimum capitalization requirements, and paid a claim, these

insurance-like traits do not overcome the arrangement's other failings because Syzygy was not operated like an insurance company. The fronting carriers charged unreasonable premiums for late issued policies with conflicting and ambiguous terms."

The court determined that Syzygy did not engage in insurance transactions and was not an insurance company. Therefore, the microcaptive election was invalid and that the premiums received were taxable income. As a result, premium payments by Highland were not payments for insurance and so not deductible as ordinary and necessary business expenses.

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