Salty Brine v. USA (Salty Brine 1, LTD, ET AL v. United States of America, 5:10CV00108 (TX U.S. Dist. Ct., North) (2012)

This case was decided in the United State District Court for the Northern District of Texas. The case primarily involved two individuals who had established partnerships and corporations relating to their estate and tax planning. The individuals owned and operated a group of oil and gas related businesses in west Texas. The various companies owned by the individuals purchased Business Protection Policies ("BPP"). An elaborate 5 step process using various entities and intermediaries was set up. At the end of a year, funds used to purchase the BPPs were then used to pay for life insurance premiums with tax deductible dollars. On the surface, as described by the court, these policies insured against various risks. However, in reality, these BPPs were used to funnel cash to buy a cash-value life insurance policy and thus the Court ruled that the payments for the BPPs were not true insurance. The companies which made the BPP premium payments could not deduct them as an ordinary and necessary business expense under Section 162 of the Internal Revenue Code.

To receive a deduction under Section 162 of the Internal Revenue Code, the court identified 5 factors. The expense must (1) be paid or incurred during the taxable year, (2) be for carrying on a trade or business, (3) be an expense, (4) be a necessary expense, and (5) be an ordinary expense. The Court decided that the facts and circumstances of the case show that the actions of the individuals were taken for tax and estate planning purposes and not for carrying on a trade or business. Further, the Court felt the actions were better classified as a distribution, rather than an expense, since funds were paid from the companies for life insurance that benefited the individuals. An expense must be "appropriate and helpful" for the development of the taxpayer's business.

The Court noted that payments for liability insurance premiums are considered an ordinary and necessary business expense. As has been discussed in past cases, insurance must contain three elements: (1) risk, (2) shifting of risk, and (3) distribution of risk. The Court held that there was no risk in the present case. The premiums charged for the BPPs were based purely on available cash flow. The coverage provided by the BPPs were tailored to provide cash flow to fund the life insurance policies. The premiums should have been determined by the risks involved, not based on the premium amount desired.

The Court also held that no risk was shifted as no real risk was transferred to a separate entity. In addition, after breaking down the elaborate structure created, the Court found that the risk of loss was still carried by the businesses. Captive insurance was specifically mentioned in the case as a legitimate separate insurance company used to shift risk. However in the present case, the arrangement did not qualify as captive insurance.

Further, no risk distribution occurred in this case as all funds were segregated and premiums were only received from one business group. The Court did not further distinguish risk distribution from past cases or revenue rulings. The previously issued safe harbor Revenue

Rulings of 2002-89 and 2002-90 describe effective ways to sufficiently achieve risk distribution, but the court failed to mention or expand on these rulings.

Lastly, the Court ruled that the transaction lacked economic substance. It found the motivation was tax avoidance, rather than a genuine business purpose. The individuals failed to provide any documentation to prove the risks were ever analyzed or quantified and therefore the BPPs that covered such “risks” could not be classified as insurance.

This case further dictates the importance of forming and running your captive insurance company as a true insurance company. It is critical that an independent analysis be conducted by licensed brokers, attorneys and actuaries to identify business risks to insure. It is of the upmost importance that an independent actuary prices the risks being insured by a captive, rather than having an individual set the premiums based on their cash flow desires. Further, once the risks are identified and priced, the risks need to be sufficiently shifted so the captive insurance company bears the burden of loss. In addition, a captive insurance company needs to distribute the risks adequately among related or unrelated entities (based on past case law and IRS guidance).