RESERVE MECHANICAL CORP. F.K.A. RESERVE CASUALTY CORP.,

Petitioner,

ELECTRONICALLY FILED

v.

Docket No. 14545-16

COMMISSIONER OF INTERNAL REVENUE,

Respondent

RESPONDENT'S MEMORANDUM ISSUES MEMORANDUM FOR RESPONDENT

UNITED STATES TAX COURT

RESERVE MECHANICAL CORP F.K.A. RESERVE CASUALTY CORP,	)	
	)	
Petitioner,	)	
	)	
v.	)	Docket No. 14545-16
	)	
COMMISSIONER OF INTERNAL REVENUE,	)	Filed Electronically
	)	
Respondent.	)	Judge Kathleen Kerrigan

ISSUES MEMORANDUM FOR RESPONDENT

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CONTENTS

CITATIONS

Page

Cases

UNITED STATES TAX COURT

RESERVE MECHANICAL CORP F.K.A. RESERVE CASUALTY CORP,	)	
Petitioner,	)	
v.	)	Docket No. 14545-16
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ISSUES MEMORANDUM FOR RESPONDENT

PRELIMINARY STATEMENT

On October 16, 2017, the Court issued an Order requiring the parties to file on or before October 31, 2017 a memorandum to address issues pertaining to Avrahami v. Commissioner, 149 T.C. No. 7 (August 21, 2017). This issues memorandum both reiterates and elaborates upon the factual and legal arguments concerning Avrahami previously raised by respondent.

ARGUMENT

I. General Discussion of Avrahami Decision

In examining a microcaptive insurance arrangement, the Avrahami Court found that the entity (Pan American) was not a *bona fide* insurance company due to "excessive premiums, an ultra-low probability of a claim ever being paid, and payments of a circular nature." Id. at 75. The Court held that the captive's reinsurance arrangement with the entity did not distribute risk and, therefore, that was sufficient alone to

determine that the captive's arrangement was not insurance for federal income tax purposes. Id. at 75-76.

In so holding, the Avrahami Court also rejected petitioner's argument that the policies issued by the captive to three or four affiliated entities created sufficient risk distribution. Id. at 62-64. The Court further held that the captive arrangement was not insurance in the commonly accepted sense as the captive "was not operated like an insurance company, it issued policies with unclear and contradictory terms, and it charged wholly unreasonable premiums." Id. at 86. (See Resp. Ans. Br., at pp. 27-29). Lastly, due to a stipulation by the parties in Avrahami, the Court did not opine on the applicability of section 881 which is at issue in the present case. Id. at 88.

II. Avrahami Refutes Petitioner's Risk Distribution Argument

As in Avrahami, the absence of risk distribution in this case *alone* is sufficient for the Court to find that a captive arrangement does not constitute insurance for federal income tax purposes. See Id. at 76. Petitioner herein fails to achieve risk distribution among its insureds, as three entities are an insufficient number to achieve risk distribution. Id. at 62-64. (See Resp. Ans. Br., at pp. 30-32).

Likewise, petitioner did not achieve risk distribution through its arrangement with PoolRe. The planning, structure,

and operation of PoolRe demonstrates that it was not a *bona fide* insurance company, but instead "part of a tax-reduction scheme papered to look like an entity engaged in insurance." Id. at 75. (See Resp. Ans. Br., at pp. 32-45).

Petitioner's experts, with the exception of Dr. Doherty discussed below, only provided opinions concerning the treatment of its arrangement as insurance for accounting, insurance industry and regulatory purposes. Further, petitioner's expert Dr. Doherty based his opinion concerning the level of risk distribution on the pooling arrangement relating to PoolRe. A determination by the Court that PoolRe is not a *bona fide* insurance company under the framework set forth in Avrahami would contradict the foundation of Dr. Doherty's opinion. If PoolRe is not a *bona fide* insurance company, petitioner cannot distribute risk through the PoolRe pool and, thus, bears the entire risk from the direct written policies.

A. PoolRe is not a *bona fide* insurance company

In Avrahami, the Court set out various factors in examining whether the entity (Pan American) was a *bona fide* insurance company. Id. at 66-67. While respondent addressed each of these factors in detail in his answering brief, we summarize the key factors again here. (See Resp. Ans. Br., at pp. 32-45). The arrangement in Avrahami is strikingly similar to the purported reinsurance arrangement between petitioner and PoolRe.

1. Petitioner's general ledgers demonstrate a circular flow of funds

In Avrahami, the reinsurance entity received premiums from a business and then transferred equal amounts as reinsurance premiums to the captive associated with that business. The Avrahami Court found this to "look suspiciously like a circular flow of funds." Id. at 68, 75. Similarly here, the premiums allegedly paid to PoolRe, as reflected in its general ledgers, were ultimately funneled back to petitioner in the same amounts, dollar for dollar, in each of the taxable years at issue. While petitioner reports the quota share reinsurance premiums that Peak purportedly paid to PoolRe in its general ledgers and on its Form 990, PoolRe is merely passing the money it received from Peak on to petitioner. Based upon the general ledgers, PoolRe retained no net insurance premiums regarding any of the payments required in the agreements. (See Resp. Ans. Br., at p. 38-39, 47-49). As Avrahami concluded about the legal effect of the petitioner's actions there, PoolRe was merely funneling the premiums of an equal amount to petitioner, resulting in a circular flow of funds, while creating the appearance of a reinsurance arrangement.

2. The premiums were "one-size-fits-all"

There is no evidence herein concerning other parties' involvement as counterparties to the reinsurance transaction, what their risks were, what amounts of exposure existed, and

what industries, locations, or operations they had. This is the case despite that under the Quota Share Agreement, petitioner was allegedly ceding a portion of its risk to PoolRe and taking on a "blended" amount of risk from all the other entities involved in the PoolRe arrangement. In a bona fide reinsurance transaction, premiums would be determined only after a reasoned analysis of those risks. (See Resp. Ans. Br., at pp. 40-41).

Capstone created the pro forma PoolRe reinsurance policies, which were not arm's-length contracts, with petitioner. The evidence supports that Capstone, not PoolRe, set the premiums at a flat 18.5 percent rate across the board for all the captives in its program regardless of the varying nature of the insureds' businesses and the diversity of the alleged risks. (See Resp. Ans. Br., at pp. 41-43). There is no evidence to show how the reinsurance premiums were calculated on behalf of PoolRe. As the Avrahami Court observed regarding the "one-size-fits-all rate for all of Clark's scores of clients", "[t]here are some rather obvious questions here". Id. at 69.

3. The lack of payments from petitioner's bank statements corroborates that there was no payment of any claims by petitioner or PoolRe under the Quota Share Agreement

In Avrahami, the Court found an "ultra-low probability" both that a claim would occur under the terms of the contract and that a qualifying loss would be paid by an already thinly capitalized insurer that returned nearly all of the premiums to

the captives. Id. at 72-73, 75. There is no evidence here to show that PoolRe was adequately capitalized.

In its answering brief, petitioner presents two new findings of fact in 96.A. and 96.B.[1] to support its position that PoolRe maintained sufficient funds to pay claims. However, these findings are not supported by the record, as there is no evidence regarding PoolRe's financial records or the funds maintained by PoolRe. (Entire record). The Quota Share Agreements cited by petitioner to support the findings of fact make reference to a final accounting, but no final accounting was introduced in evidence. (Entire record). Assuming PoolRe operates with the other captives in the structure as it does with petitioner, PoolRe has no reserves to pay any claims. The funds PoolRe receives from each captive under the Quota Share Agreement are returned shortly thereafter to each such captive in the same amount as quota share reinsurance premium. (Entire Record).

Moreover, petitioner has not proven the payment of any claims by PoolRe. There is evidence, however, to show that petitioner did *not* pay claims under the PoolRe arrangement. In fact, if PoolRe had paid claims, petitioner would be responsible for payment of a pro rata portion of any such claim under the

[1] Respondent intends to file a motion for leave to respond to petitioner's proposed findings of fact 96.A. and 96.B. raised in its answering brief, and intends to concurrently lodge respondent's objections and responses thereto.

quota share reinsurance arrangement between petitioner and PoolRe. The lack of payments from petitioner's bank statements corroborates that there was no payment of any claims by petitioner or PoolRe pursuant to the PoolRe arrangement. (See Resp. Ans. Br., at p. 45).

B. Petitioner's purported reinsurance arrangement with PoolRe did not distribute risk

In Avrahami, the Court focused on the circular flow of funds, the unreasonableness of the premiums, and the lack of arms-length contracts in holding that the entity (Pan American) was not a *bona fide* insurance company. 149 T.C. No. 7, at 75. As in Avrahami, PoolRe is also not a *bona fide* insurance company, but rather part of a structured transaction promoted by Capstone to shelter income.

In Avrahami, the Court rejected the argument that sufficient risk distribution existed from policies issued by the captive to three or four affiliated entities. Id. at 62-64. Absent the circular PoolRe reinsurance arrangement, petitioner is similarly left with only its three insureds, and petitioner's captive insurance arrangement does not constitute insurance for federal income tax purposes.

III. Avrahami Contradicts Petitioner's Argument that its Arrangement is Insurance in the Commonly Accepted Sense

Courts consider the reality of the transaction in determining the existence of insurance in the commonly accepted

sense. Avrahami, 149 T.C. No. 7, at 76. In the present case, the reality is that the transactions were entered into solely for tax purposes, not insurance purposes.

The evidence concerning the processing of petitioner's only claim shows that petitioner was not operated like an insurance company. Instead, a Peak employee, not affiliated with petitioner, signed a series of checks to transfer money to Peak without any investigation of the claimed loss of business. Further, there is no evidence of petitioner's actual operations; its owner, Zumbaum, didn't know what petitioner actually did in Anguilla. (See Resp. Ans. Br., at pp. 54-56). An attempt to show the legitimacy of petitioner's operations by reference to Anguilla's statutory insurance requirements is also misleading, as the requirements are so minimal that they could be easily satisfied. Accord, Avrahami, 149 T.C. No. 7, at 75.

Petitioner's premiums were fixed by Capstone and only served to improperly maximize Peak's tax benefits. No contemporaneous documentation exists supporting negotiated arm's length dealing or the use of any principled premium pricing methodology. Peak's insurance premium expense actually increased by over $400,000 each year after petitioner was formed. In 2008, petitioner charged $412,089 for one month of purported coverage, while the annual premiums for 2009 and 2010 for nearly identical coverage were $448,127 and $445,314,

respectively. The premiums were unreasonable and unsupported. (See Resp. Ans. Br., at pp. 56-58). Further, the policies are incomplete and contain errors. (See Resp. Ans. Br., at pp. 58-59). As in Avrahami, the policies were "less than a model of clarity." Id. at 81.

Finally, petitioner was not formed to manage Peak's risks or reduce Peak's insurance costs. Instead, the micro-captive arrangement *increased* Peak's insurance costs. The risks of Peak's business remained with its pre-existing third party commercial insurance policies, which continued in force even after petitioner was organized and issued policies. Petitioner's owners were attracted by the tax benefits of a micro-captive insurance company, not a legitimate insurance arrangement. Notably, there is no evidence that Peak consulted with any insurance professional or organization other than Capstone in considering such a captive arrangement. (See Resp. Ans. Br., at pp. 59-62).

As in Avrahami, the primary reason for Peak and its affiliates to acquire insurance from petitioner was neither legitimate nor for it to conduct business. Petitioner's premiums were unreasonable and unsupported. Petitioner was not operated as an insurance company. The Avrahami Court asked "does [the captive] add up to 'insurance in the commonly accepted sense?'" and concluded that the answer must be "no", as

the arrangement's "insurance-like traits" could not overcome the captive's other failings. Id. at 86. For the same reason, petitioner's captive arrangement is not insurance in the commonly accepted sense and, thus, is not insurance for federal income tax purposes.

CONCLUSION

It follows that the determination of the Commissioner of Internal Revenue should be sustained.

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Date: October 31, 2017

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