Case Nos. 18-9011

In the

United States Court of Appeals

for the

Tenth Circuit

RESERVE MECHANICAL CORP., f/k/a Reserve Casualty Corp.,

Petitioner-Appellant,

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent-Appellee.

Appeal from a Decision of the United States Tax Court
Case No. 014545-16 · Honorable Kathleen Kerrigan

MOTION FOR LEAVE TO FILE BRIEF *AMICI CURIAE* OF THE ALABAMA CAPTIVE INSURANCE ASSOCIATION, INC., ARIZONA CAPTIVE INSURANCE ASSOCIATION, INC., DELAWARE CAPTIVE INSURANCE ASSOCIATION INC., GEORGIA CAPTIVE INSURANCE ASSOCIATION, INC., HAWAII CAPTIVES INSURANCE COUNCIL, KENTUCKY CAPTIVE ASSOCIATION, INC., MISSOURI CAPTIVE INSURANCE ASSOCIATION, MONTANA CAPTIVE INSURANCE ASSOCIATION, INC., NORTH CAROLINA CAPTIVE INSURANCE ASSOCIATION, UTAH CAPTIVE INSURANCE ASSOCIATION, AND SELF INSURANCE INSTITUTE OF AMERICA IN SUPPORT OF PETITIONER-APPELLANT

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MOTION FOR LEAVE TO FILE BRIEF AMICUS CURIAE

Amici curiae listed below respectfully move for leave of Court to file the accompanying brief. All parties have consented to the filing of this brief.

INTERESTS OF AMICI CURIAE

Amici are ten independent trade organizations from various States and the Self-Insurance Institute of America, Inc. ("SIIA").

State Organizations: The ten unaffiliated trade organizations represent the interests of their members mainly within a single given State and under the statutes and regulatory authority of a single given state (e.g., Alabama, Arizona, Delaware, Georgia, Hawaii, Kentucky, Missouri, Montana, North Carolina, and Utah). The membership of the State organizations primarily includes captive insurance companies and their owners, captive insurance managers, attorneys, actuaries, investment managers, certified public accountants, and others. Each of these captive insurance associations promotes the compliant and solvent operation of captive insurance companies through professional education, networking events, and engagement in legislative and regulatory affairs.

Self-Insurance Institute of America, Inc. ("SIIA") is a nonprofit, 1000-member association dedicated to the advancement of the self-insurance industry, with a nationwide scope. SIIA's membership includes self-insured entities, third-party administrators, captive owners and managers, excess and stop-loss insurance carriers, and industry service providers (ranging from small professional firms to large commercial insurers). Through SIIA, members develop industry best practices, receive and disseminate education on industry issues and engage state and federal policymakers and regulators on a range of subjects relevant to the effective functioning of captive insurance programs and the nation's self-insurance systems, including self-funding health plans, worker's compensation plans, liability plans, and property plans.

Amici submit this brief to bring to the Court's attention three issues that bear on the decision of this case. In particular, *amici* show that, regardless of whether the Court reserves or affirms the Tax Court below based on case-specific evidence at trial, the Court should take care that its opinion does not suggests new limits on widely accepted and long-standing principles of insurance and tax law which could have wide-ranging unintended consequences. Because the Tax Court's opinion misconstrues certain elements of tax and insurance law to support its decision against the taxpayer, the decision was in error and must be reversed or modified.

For these reasons, *amici* respectfully request that the Court grant leave to file the accompanying brief.

Dated: February 27, 2020

Respectfully submitted,

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CERTIFICATE OF DIGITAL SUBMISSION

Counsel for *Amici Curiae* in Support of Petitioner-Appellant hereby certifies that all required privacy redactions have been made, which complies with the requirements of Federal Rule of Appellate Procedure 25(a)(5).

Counsel also certifies that any and all hard copies submitted to the Court are exact copies of the ECF filing from February 27, 2020.

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CERTIFICATE OF SERVICE

I hereby certify that on February 27, 2020, I electronically filed the foregoing with the Clerk of the Court for the United States Court of Appeals for the Tenth Circuit by using the appellate CM/ECF system.

I certify that all participants in the case are registered CM/ECF users and that service will be accomplished by the appellate CM/ECF system.

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CORPORATE DISCLOSURE STATEMENT

Pursuant to Rule 26.1 of the Federal Rules of Appellate Procedure, *amici curiae* certify as follows:

Amici have no parent corporations, are not publicly held corporations, and no publicly-held corporation owns ten percent or more of the organizational stock of any amicus party.

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STATEMENT OF THE INTERESTS OF AMICUS CURIAE[1]

Amici are ten independent trade organizations from various States and the Self-Insurance Institute of America, Inc ("SIIA"), a national organization.

State organizations. The State associations are unaffiliated trade organizations representing the interests of their members mainly within a single given State. The membership of the State organizations primarily includes captive insurance companies and their owners, captive insurance managers, attorneys, actuaries, investment managers, certified public accountants, and others. Each of these captive insurance associations promotes the compliant and solvent operation of captive insurance companies through professional education, networking events, and engagement in legislative and regulatory affairs.

Nearly 2000 captive insurance companies are domiciled in and regulated by the States of Alabama, Arizona, Delaware, Georgia, Hawaii, Kentucky, Missouri, Montana, North Carolina, and Utah. Moreover, many of these 2000 captive insurance companies are group captive insurance companies or protected cell captive insurance companies, each of which houses the captive insurance programs

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[1] No party or counsel for a party authored this brief, in whole or in part. No one other than *amici* or their counsel made a monetary contribution to preparing or submitting this brief. Each of the parties has consented to the filing of this brief, as a majority of the members of the boards of directors or executive committees of the boards of directors of each of these associations voted to approve the filing of this brief.

of a number of unrelated businesses. So there are well over 2000 unique participants. Nationally, the scope of the industry is even greater. At least 19 other states have passed captive insurance enabling legislation, demonstrating a healthy and material industry in the United States.[2]

Self-Insurance Institute of America, Inc. ("SIIA") is a nonprofit, 1000-member association dedicated to the advancement of the self-insurance industry. SIIA's membership includes self-insured entities, third-party administrators, captive owners and managers, excess and stop-loss insurance carriers, and industry service providers (ranging from small professional firms to large commercial insurers). Through SIIA, members develop industry best practices, receive and disseminate education on industry issues and engage policymakers and regulators on a range of subjects relevant to the effective functioning of captive insurance programs and the nation's self-insurance systems, including self-funding health plans, worker's compensation plans, liability plans, and property plans.

Amici file this brief with a straightforward objective: regardless of whether the Court affirms or reverses the decision below on other grounds or other case-specific evidence, it should take care that nothing in its opinion suggests new limits

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[2] *Captives by State*, A Firm Foundation: How Insurance Supports the Economy, Insurance Information Institute, https://www.iii.org/publications/a-firm-foundation-how-insurance-supports-the-economy/a-50-state-commitment/captives-by-state (last visited Jan. 15, 2020).

on widely accepted and long-standing principles of insurance and tax law. At a minimum, amici ask the Court to confirm that:

> (1) a policyholder is not required to show a prior loss history for any line of coverage as a prerequisite for the coverage to be insurance for regulatory purposes or to qualify as insurance for federal income tax purposes,
>
> (2) an insurance policy need not be individually manuscripted and negotiated to qualify as insurance for regulatory purposes or federal income tax purposes, and
>
> (3) a risk pool does not fail to satisfy the requirements of *The Harper Insurance Group v. Commissioner* and the regulatory and tax tests of insurance and does not fail to provide sufficient risk distribution merely because the insurance premiums paid into the pool were identical in amount to the dollars ceded to ultimate reinsurers.

Because the Tax Court misconstrued those three elements to support its decision against the taxpayer, the decision was in error and must be reversed or modified.

BACKGROUND ON INSURANCE REGULATION

Insurance Regulation

State-based insurance regulation has a more than 100-year history of success in the United States. Congress, in passing the McCarran-Ferguson Act of 1945, exclusively reserved to the States the power to regulate insurance. The States, the District of Columbia and five territories each participate in this national system of state-based regulation.

The McCarran-Ferguson Act states that "[n]o Act of Congress shall be construed to invalidate, impair, or supersede any law enacted by any State for the purpose of regulating the business of insurance." 15 U.S.C. § 1012. Congress has concluded that "the business of insurance, and every person engaged therein, shall be subject to the laws of the several States which relate to the regulation or taxation of such business." *Id*. As a result, every State has comprehensive insurance regulation and oversight capabilities.

Twenty-eight States and the District of Columbia permit licensing and regulation of captive insurers. In these domiciles, the applicable regulator has the authority to issue an insurance license subject to ongoing oversight after conducting a regulatory review. Many States have dedicated staff that exclusively service and regulate captive insurance.

Outside the United States, insurance is often regulated at the national level. The insurance laws of many non-U.S. domiciles do not provide expressly for captive insurance, and their regulatory bodies generally do not distinguish between traditional insurance and captive insurance. However, the insurance laws of these offshore domiciles generally do provide for classes of insurer that correspond to captive insurance companies, and their regulators are experienced and sophisticated in identifying and addressing the distinctions between commercial insurers and captive insurers. As a result, the captive insurance operations of many U.S. taxpayers are established in offshore domiciles.

Robust Regulatory Standards

Domiciles that regulate captive insurance universally require each license applicant to complete background checks, maintain certain capital levels, and provide financial information on demand. The vast majority also require annual review by independent actuaries, as well as annual audits by independent CPAs and/or examinations by the regulator, among other requirements.

The standards and requirements that regulators impose on insurance companies and on captives in particular are intended to protect policyholders by ensuring solvency. The standards and requirements are remarkably consistent, similar around the globe, and can address all aspects of insurance company

operation, including the subject of the insurance, the characteristics of the insurance policies and the structure of reinsurance arrangements.

Amici know of no State or offshore insurance regulatory regime that requires (1) prior loss history to establish a need for insurance, (2) individually manuscripted or negotiated language for valid policies, or (3) inequitable pooling arrangements for the distribution of risk. For the Tax Court to impose these requirements in this case is to impose requirements that are inconsistent with both domestic and international insurance market practice, and established insurance doctrine and law, all of which have been previously accepted by the IRS. Over the years, the IRS has repeatedly issued guidance on insurance arrangements: the risk must contemplate the fortuitous risk of a stated contingency, and the transaction must constitute insurance in the commonly accepted sense. *See* IRS PLR 200950016 (Dec. 11, 2009) (citing *Helvering v. Le Gierse*, 312 US 531 (1941)).

The requirements articulated by the Tax Court in *Reserve Mechanical* are not found in any IRS guidance. In fact, *Reserve Mechanical* directly contravenes the IRS' substantive guidance on more than one level. *See e.g.*, IRS Private Letter Ruling ("PLR") 200907006 (Feb. 13, 2009) (finding the transaction constituted insurance where company assumed a quota share of the premiums from the reinsurance pool equivalent in dollar terms to the amount it ceded on each line of insurance); IRS PLR 201219009 (May 11, 2012) (same); IRS PLR 201219011

(May 11, 2012) (same); IRS PLR 201224018 (Jun. 15, 2012) (same); *see also* IRS PLR 200950017 (Dec. 11, 2009) (finding that the transaction included sufficient risk distribution and therefore constituted insurance notwithstanding that the insureds "each ha[d] been issued policy forms that [were] identical in all material respects"); IRS PLR 200950016 (Dec. 11, 2009) (same).

ARGUMENT

I. The Tax Court erred in its application and analysis of insurance law and principles when it required an insured show a prior loss history for the arrangement to qualify as insurance for federal income tax purposes.

The Tax Court erred when it did not consider the concept of fortuitous loss and instead held that prior loss history was an indication of actual need for insurance. 2018 WL 3046596 at *60. Indeed, fortuitous loss, the cornerstone principle of insurance law, was never mentioned in the Tax Court's opinion. The Tax Court determined that certain policies were not bona fide insurance and that "there was no legitimate business purpose for the policies," and that the policies "were not insurance . . . in the commonly accepted sense." *Id*. at *62. In reaching these conclusions, the Tax Court reasoned that the taxpayer did not have an "actual need" for the insurance because the taxpayer did not have prior losses that would have been covered by the insurance and the taxpayer had "never come close to exhausting its policy limits." *Id*. at *60.

The Court's reasoning is based on an incorrect standard. The Tax Court should have considered only whether there was a risk of fortuitous loss. Instead, it substituted a requirement that a policyholder must first have suffered a previous similar loss. Requiring a policyholder to have suffered a previous similar loss before it will recognize a policy as being *bona fide* insurance is a requirement which does not exist in insurance law and which upends centuries of insurance practice and legal reasoning.

This flawed analysis puts the taxpayer in the absurd position of only being able to buy insurance after it has suffered a loss. But the purpose of insurance is to prevent financial harm from a fortuitous potential loss. One's house does not have to burn down before one can buy fire insurance. Under the Tax Court's theory, a taxpayer must always suffer harm from at least one loss and can only insure against further harm from additional similar losses.

Instead, the court should have applied traditional insurance principles and considered whether they provide indemnity for a fortuitous risk. "A fortuitous event . . . is an event which so far as the parties to the contract are aware, is dependent on chance." *Markwest Hydrocarbon, Inc. v. Liberty Mut. Ins. Co.*, 558 F.3d 1184 (10th Cir. 2009) (*quoting* Jane Massey Draper, *Coverage Under All-Risk Insurance*, 30 A.L.R.5th 170 (1995) ("[A] fortuitous event [is] one that is

unexpected and not probable, and caused by an external force, that is, not resulting from an internal characteristic of the property.”)).

By ignoring fortuity and developing its own rationale, the Tax Court created a requirement untethered to insurance law; determining that certain policies at issue were not bona fide insurance because the policyholder had not suffered a prior loss. 2018 WL 3046596 at *43–44, 57, 60. The Tax Court reasoned that PoolRe, and thus Reserve, did not face any “actual and insurable risk” because “Reserve provided no evidence of the amount of that purported loss or the likelihood that something like it would happen again.” *Id*. at *44. The Tax Court also explained that the “history of losses for Peak and the other insureds shows that before the tax years in issue they never suffered any losses that would even come close to triggering the stop loss coverage.” *Id.* This is not an appropriate way to define “actual and insurable risk.”

Further, this approach does not follow other cases. In *AMERCO*, the Ninth Circuit explained that “insurance risk is the possibility that a particular event for which an insured will be held liable will occur. Of course, from the standpoint of the insured there can be no profit from that risk. The only possible outcomes are loss or no loss. It is that risk which must be transferred to the insurer if true insurance is to be involved.” *AMERCO, Inc. v. Comm’r*, 979 F.2d 162, 167 (9th Cir. 1992); s*ee also Ocean Drilling Exploration Co. v. U.S.*, 988 F.2d 1135, 1150

(Fed. Cir. 1993) (finding arrangement protected against variability of loss and stating "the risk dimension that is being transferred is the unpredictability or variability of loss and not the expected loss or long run average cost.").

Under the Tax Court's analysis here, a fire insurance policy would be inappropriate without a prior fire loss. A cyber policy would be inappropriate without a prior ransomware event. A coastal windstorm policy would not be real insurance unless a property had already been destroyed by a hurricane. These examples underscore the impropriety of substituting the Tax Court's requirement of a prior loss for the long-standing requirement of fortuitous risk of future loss. It is the potential for future loss, not the presence or absence of prior loss, which ultimately characterizes insurance.

The Tax Court reasoned that there was insufficient evidence that the taxpayer had legitimate liability concerns to justify the purchase of additional insurance. *Id*. at *60–61. By imposing its belief about what are sufficient levels of insurance, the Tax Court substituted its own judgment for the business judgment of the owners.

There was testimony on behalf of the taxpayer that there were additional liability concerns prompting the purchase of insurance. Considering that the taxpayer's industry (mining) is extraordinarily dangerous, and further considering that companies often pay significant sums to settle defensible claims, the

taxpayer's concern may have been warranted. The mere fact that the taxpayer "had never come close to exhausting the policy limits of its third-party commercial insurance coverage," *Id*. at *60, does not negate the fact that it was subject to potentially ruinous fortuitous liability if its mine ventilation equipment were to be implicated in a mining disaster. This catastrophic risk is precisely why companies buy insurance.

II. The Tax Court erred when it criticized the use of standard form policies.

In evaluating whether Reserve's transactions constituted insurance in the commonly accepted sense, the Tax Court considered many factors, including whether the policies issued by Reserve were valid and binding. *Id*. at *48. In concluding that evidence on the validity of the policies was mixed, the Tax Court criticized the use of standardized, so-called "cookie cutter policies." *Id*. at *54.

The Tax Court critiqued the use of "cookie cutter policies" because they "indicate they were the copyrighted material of [the captive manager], and [the captive manager's] employees testified at trial that they administered many of the same policies for all of their clients." *Id*. at *54. The Tax Court's comments could be read to require custom written—i.e., manuscripted—policies in order for the Tax Court to conclude that the policies were valid and binding. This differs from the great weight of insurance law and practice, where standardized form contracts are the norm, and manuscripted policies the narrow exception. One need look no

further than homeowners, auto, business owner or general liability to see common lines of coverage that rely almost exclusively on standardized provisions.

The Supreme Court approved the use of form contracts in insurance as early as 1913. In *German Alliance Ins. Co. v. Lewis*, 233 U.S. 389, 412 (1914), Justice McKenna recognized that "the price of insurance is "promulgated" in "practically controlling constancy which the applicant for insurance is powerless to oppose." *Id*. at 416-17. The use of form contracts in insurance—like the form contracts then used by railroads, coaches, grain elevators, and hotels—was not questioned by the Court. *Id*. at 17.

Since then, courts have widely recognized the economic efficiencies which form contracts—the same "cookie cutter" contracts derogated by the Tax Court—bring to the commercial marketplace. *See, e.g., Westfield Ins. Co. v. Galatis*, 100 Ohio St. 3d 216 (2003) ("The insurance industry customarily uses standardized forms promulgated by the Insurance Services Office, Inc. ('ISO'). The ISO forms are generically written to provide for the insurance needs of a wide range of policyholders."); *Pardee Const. Co. v. Ins. Co. of W*, 77 Cal. App. 4th 1340, 1362 n.15 (2000) ("ISO is a nonprofit trade association that provides rating, statistical, and actuarial policy forms and related drafting services to approximately 3,000 nationwide [insurers] . . . most carriers use the basic ISO forms, at least as the starting point for their general liability policies.").

In fact, standardized policy forms are the norm in the commercial property and casualty insurance industry. They both lower transaction costs in the contract formation stage and increase certainty for the parties because many clauses taken from form commercial contracts have already been well tested in the country's common law courts. As a result, most commercial property and casualty insurance policies include the same basic standard terms and language. Because the forms are standard, they are often used satisfactorily, even where they may contain certain provisions that are not necessarily applicable or useful in given circumstances.

The Tax Court also criticized the use of standardized policies because it concluded that these policies "were not reasonably suited to the needs of [certain] insureds . . . which had extremely limited operations." *Id*. at *54. This attack again ignores commercial reality. Because the forms are standard, commercial insurance contracts often provide coverage or include provisions covering risks which are very remote for certain policy holders. Further, enterprises with multiple entities are often insured under policies that cover all of the entities, regardless of whether each entity's unique operations make all of the coverages or contract provisions necessary for that entity.

Captive insurers and captive managers have found in standardized insurance contracts the same efficiencies that the commercial market has found. Common

lines of coverage are routinely based on standard forms. Commercial insurance pools also rely on standard policy forms so that all participants can understand what losses are covered and so that each participant can have certainty as to which risks of its fellow participants it is covering. The Tax Court erred in concluding that standardized insurance policies do not constitute insurance in the commonly accepted sense, when in fact, the commercial insurance market operates just this way.

III. The Tax Court erred in concluding that a risk pool fails to achieve risk distribution when the premiums paid to the pool are identical in amount to the premiums paid by the pool to its reinsurers.

The Tax Court concluded that the pooling was an improper "circular flow of funds." *Id*. at *41–42. However, the Tax Court erred in this conclusion because it mischaracterized a routine commercial transaction that is regularly used within the insurance industry.[3] Rather than a circular flow of funds, a pooling transaction is one that materially changes its participants' economic positions by mixing the risks they insure.

Commercial insurers regularly pool their risks among affiliated companies by ceding premium to the pool and taking back a like amount of premium

[3] *See, e.g.*, *Commercial Insurance and Captive Insurance Industry: Commonly Accepted Practices*, Cicaworld.com, 3–4 (Jan. 31, 2019), http://www.cicaworld.com/docs/default-source/default-document-library/cica_commonly_accepted_insurance_practices_risk_pools_jan2019.pdf?sfvrsn=0 [hereinafter *Commonly Accepted Practices*].

expressed as a percentage, also known as a quota share, of the pool's premium and corresponding risk. Although the same amount of premium may flow into and back from the pool, these arrangements have a real economic effect that is so material that AM Best, when evaluating these companies, analyzes and reports on the substance of reinsurance pooling agreements.

Leading insurance experts describe the relationship between premiums and risk in the typical pooling arrangement as one of proportionality:

> The captive cedes the risk or a portion of the risk to a pool, paying reinsurance premiums in return for the pool assuming the risk. The captive then reinsures the pool, i.e., takes back a quota share of the unrelated risks in the pool, and receives reinsurance premiums in return….
>
> The amount of premium and risk that the captive assumes from the pool will typically be approximately the same amount as was ceded. However, the captive assumes liability for paying not the losses of its original insured but a share of all losses incurred by the pool participants.[4]

[4] *See* Kathryn A. Westover, *Captives and the Management of Risk*, International Risk Management Institute, Inc. 2002, pages 88-90; *see also* Appleman on Insurance Law & Practice Archive § 10999 n.6 (2nd 2011) (citing *Crawford Fitting Co. v. United States*, 606 F. Supp. 136, 147 (holding that amount paid by taxpayer to captive insurance company as insurance premium was deductible as ordinary and necessary business expense where taxpayer did not form company for purpose of tax avoidance or evasion, company was separate and independent corporate entity, [and] *premiums charged were actuarially based and proportionate to covered risks*) (emphasis added)); IRS Chief Counsel Advisory 200844011 (Oct. 31, 2008) (describing a typical equitable pooling arrangement as one in which the pool member assumes a level of risk proportionate to the value of the premiums it pays).

Similarly, as explained by the Captive Insurance Companies Association, actuaries articulate the losses flowing to and from a risk pool as follows:

> Each captive has coverage for its own losses and cedes these losses to the pool for recovery. In turn, the captive assumes back its quota share of the pool's losses. *While premiums ceded and assumed are equal, the losses ceded and assumed are not.* The losses assumed by the captive are in all likelihood more diversified and less variable than the losses ceded. (The diversification may stem from the larger number of exposures insured or from a broader array of exposures being insured by geography, coverage, industry, insurance classifications, etc.)
>
> More diversified losses should be less variable and therefore more predictable. This is an essential element in risk transfer and is one of the hallmarks of insurance. The business purpose for the captives participating in such a pool—to reduce the risk profile of their retained losses—is met in this way. Plus, structured in this way, the premiums ceded (transferred) to the pool will by definition equal the premiums assumed (received) back from the pool. This equivalence of premiums is not a "circular flow of funds," but rather a natural consequence of arm's length transactions; the risks ceded (transferred) for a given premium equal the risks assumed, which must, by definition, be equal to the same premium (subject to any ceding commissions).[5]

By failing to follow the flow of risks into and out of the pool, the Tax Court simply misunderstood the common insurance transaction of risk pooling, and mischaracterized it as a circular flow of funds.

A. The shifting and distribution of risk by the use of pools.

The United States Supreme Court recognized over a century ago that "the effect of insurance—indeed, it has been said to be its fundamental object—is to

[5] *Commonly Accepted Practices*, *supra* note 2, at 5–6 (emphasis in original).

distribute the loss over as wide an area as possible." *German Alliance Ins. Co. v. Lewis*, 233 U.S. 389, 412 (1914). That impact—risk distribution—spreads the loss "over the country, the disaster to an individual is shared by many, the disaster to a community shared by other communities; great catastrophes are thereby lessened, and, it may be, repaired." *Id*.

Neither the Internal Revenue Code (written by Congress) nor the Commissioner's own tax regulations provide a definition of "insurance." *Clougherty Packing Co. v. Comm'r*, 811 F.2d 1297, 1301 (9th Cir. 1987). The accepted definition for purposes of federal income taxation dates to 1941 when the Supreme Court stated that "[h]istorically and commonly insurance involves risk-shifting and risk-distributing." *Helvering v. Le Gierse*, 312 U.S. 531, 539, (1941); *see Comm'r v. Treganowan,* 183 F.2d 288, 291 (2d Cir. 1950); B. Bittker, 5 Federal Taxation of Income, Estates & Gifts ¶ 127.2 at 127.7 (1984) ("Under *[LeGierse]* the shifting and distribution of the risk of death are indispensable elements of life insurance.").

Shifting risk requires the transfer of the impact of a potential loss from the policyholder to the insurer. If the policyholder has shifted its risk through insurance, then a loss by or a claim against the policyholder does not affect it because the loss is offset by the proceeds of an insurance payment. *See Beech Aircraft Corp. v. United States*, 797 F.2d 920, 922 (10th Cir.

1986); *Treganowan*, 183 F.2d at 291; O'Brien & Tung, *Captive Off-Shore Insurance Corporations,* 31 N.Y.U. Inst. 665, 683–84 (1973).

Distributing risk allows an insurer to reduce the possibility that a single costly claim will exceed the amount taken in as a premium and set aside for the payment of such a claim. Similarly, a pool's mixing and sharing risks from multiple insureds across diversified industries ensures that no single company, industry, or geographic area has too much risk concentrated in its pool. "Insuring many independent risks in return for numerous premiums serves to distribute risk." *Clougherty Packing Co.*, 811 F.2d at 1300. By assuming numerous relatively small, independent risks that occur randomly over time, the insurer smooths out losses to match more closely its receipt of premiums. *Id.* (citing 797 F.2d at 922; *Treganowan,* 183 F.2d at 291).

The concept of risk distribution incorporates the statistical phenomenon known as the law of large numbers. "This law is reflected in the financial world by the diversification of investment portfolios and in the day-to-day world by the adage 'Don't put all your eggs in one basket.'" *Clougherty Packing Co.*, 811 F.2d at 1300. And, "as the size of the pool increases the law of large numbers takes over, and the ratio of actual to expected loss converges on one. The absolute size of the expected variance increases, but the ratio decreases." *Sears, Roebuck and Co. v. Comm'r*, 972 F.2d 858, 862 (7th Cir. 1992).

In other words, pooling reduces volatility because the potential for catastrophic losses to an individual is turned into a statistical likelihood of smaller, more manageable losses for the pool participants. Additionally, although risk pooling, or risk distribution, is driven by the economic incentive to reduce volatility and spread large losses in small bits over multiple parties, a natural result and additional benefit of risk pooling is a transaction that qualifies as insurance for tax purposes. Both cases (and the IRS's reliance on caselaw) have accepted and acknowledged benefits of pooling. Rev. Ruls. 2002-89 and 2002-90. *See* IRS PLR 201030014 (Jul. 30, 2010) (citing Rev. Rul. 2002-89 for proposition that an arrangement between parent and wholly-owned subsidiary is insurance if other insureds constitute more than fifty percent of total risk and citing Rev. Rul. 2002-90 for proposition that an arrangement between a licensed subsidiary and each of parent's twelve operating subsidiaries constituted insurance where no one subsidiary accounts for less than five percent, or more than fifteen percent, of the total risk insured); IRS PLR 201219009 (May 11, 2012) (same), IRS PLR 201219010 (May 11, 2012) (same), IRS PLR 201219011 (May 11, 2012) (same), IRS PLR 201224018 (June 15, 2012) (same).

Insurance occurs when risk is shifted and distributed. The courts and the IRS have consistently agreed that pooling is an essential element of risk

distribution. The Tax Court's decision in *Reserve*, which derogates pooling, should be viewed skeptically.

B. Risk pools are widely used in commercial insurance and self-insurance.

The Tax Court erred in finding that risk pooling was inherently suspect. Risk pools have long been recognized as valid and effective means of facilitating risk distribution. For decades, local government units have used intergovernmental pooling to spread risk among members. The Association of Governmental Risk Pools estimates that at least 80% of local public entities (over 90,000) participate in at least one risk pool.[6] For example, Colorado, Maine, North Carolina and Iowa permit local public entities to contribute to risk pools and use risk pools to manage and finance future fortuitous risk. *See* Colo. Rev. Stat. Ann. § 24-10-115 (West); Me. Rev. Stat. tit. 30-A, § 2253; N.C. Gen. Stat. Ann. § 58-23-5; Iowa Code Ann. § 670.7 (West). Notably, these intergovernmental pools are not licensed or regulated by any insurance regulator. But they are generally viewed as insurance for legal purposes because they distribute risk.

Similarly, countless residual market pools across the U.S. insure risks which commercial insurers will not write (such as mandatory worker's compensation or high-risk automobile liability insurance for motorists with poor driving records).

[6] *Commonly Accepted Practices, supra* note 2, at 3.

See IRMI Glossary, IRMI.com, https://www.irmi.com/term/insurance-definitions/residual-market (last visited Jan. 15, 2020) ("Residual markets require insurers writing specific coverage lines in a given state to assume the profits or losses accruing from insuring that state's residual risks in proportion to their share of the total voluntary market premiums written in that state.").

Pools organized as group captive insurance companies but that operate on the same risk distribution principles as quota share pools amalgamate risks among members of the same industries, such as the oil industry,[7] nuclear power industry,[8] airline industry[9] and the commercial shipping industry.[10] In fact, shipping risk pools cover 90% of the world's oceangoing shipping tonnage.[11] The IRS tacitly approved of the oil industry's pool by basing a favorable revenue ruling on its facts. Rev. Rul. 78-338, 1978-2 C.B. 107 (1978).

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[7] Oil Insurance Limited, *Oil History*, https://www.oil.bm/about-oil/at-a-glance (last visited Jan. 15, 2020).

[8] Nuclear Electric Insurance Limited, 2016 Annual Report, https://myneil.com/media/1154/2016-annual-report-financials.pdf (last visited Jan. 15, 2020).

[9] Global Aerospace, *History*, https://www.global-aero.com/about/history (last visited Jan. 15, 2020).

[10] International Group of P&I Clubs, *Group Agreements*, https://www.igpandi.org/group-agreements (last visited Jan. 15, 2020).

[11] *Id.*

In addition to these examples, commercial insurers and their affiliates frequently organize quota share pooling arrangements among themselves. Each of these pools generally uses the same risk transfer mechanisms which the Tax Court characterized as a circular flow of funds. Pools accept risk, mix the risk and return the mixed risk. Like the risk, premium necessarily flows both ways and is mixed. As a result, the risks and the funds that go into a pool, and the risks and the funds that are returned from the pool, are completely different, leaving the insurers holding a well-diversified basket of risks after the pooling and quota share transactions.

C. Risk pools are also commonly used in the captive insurance industry.

Risk pools and the manner in which risk and funds flow into them, are mixed by them and flow back from them have long been established and have been acknowledged by the IRS. At least three different captive insurance pooling models have been approved by the IRS. In one model, known as a fronting model, a single insurance company issues policies directly to numerous unrelated insureds, and then reinsures portions of each of the respective risks to numerous captives affiliated with the insureds. *See* IRS PLR 200950016 (Dec. 11, 2009) (describing fronting arrangement); *see also* (*Reliance Ins. Co. v. Shriver, Inc.*, 224 F.3d 641 (7th Cir. 2000); Thomas Holzheu, Alternative Risk Transfer (ART) Products in

Reinsurance: Fundamentals and New Challenges 113, 117 (Ruth Gastel ed., 4th ed. 2004).

In another model, known as a retrocessional model, insureds purchase insurance directly from their related captives, each captive subsequently reinsures to a pooling company, and then takes back portions of all the reinsured risks in a retrocession from the pooling company. *See* IRS PLR 200907006 (Nov. 10, 2008) (describing retrocessional arrangement). Finally, in a third model, known as a contractual exchange model, a number of unrelated insureds purchase insurance from their respective captives, and then the captives collectively enter into a single multi-party agreement to distribute each respective loss across all of the captives. *See* IRS PLR 201219011 (Feb. 3, 2012) (describing example of the contractual exchange model). In each model, the amount of premium put into the pool by each taxpayer and the premium taken back from the pool by each taxpayer are virtually the same.

Notwithstanding that the IRS has approved several similar arrangements, the Tax Court criticized the arrangement in this case for what it described as a circular flow of funds. *Amici* know of no case wherein "circular flow of funds" is defined or, to the extent it may have negative connotations, where those negative connotations are articulated. The IRS has alleged that an improper circular flow of funds occurred where a taxpayer paid premium to its captive, but that premium

was promptly returned to the taxpayer through another transaction. For example, in *Rent-A-Center*, the captive purchased treasury stock of its parent, and the IRS alleged the transaction was an improper circular flow of funds. 142 T.C. 1, 7 (2014). But there, improper circular flow of funds was never defined and the Tax Court concluded that the transaction was proper. In captive pooling transactions, there is no recycling of premium back to the taxpayer. In fact, far from being an arrangement with negative connotations, a pooling arrangement is one that results in the economic good of shifting large losses from single insurers and distributing them, in the form of many much smaller losses, across numerous insurers.

The Tax Court in *Reserve* was disturbed by the fact that premium into the pool and premium out of the pool were the same. Under the terms of the pooling arrangement, each participant transferred risk into the pool and received an equal amount of risk in exchange. Because the quantity of risk ceded to the pool and assumed from the pool were the same, the premiums ceded and assumed were the same. However, without such an equitable distribution of premium, a pooling arrangement would not be fair and would, therefore, not be tenable among pool participants that are unrelated to each other. If one participant takes back less premium than it puts in, and another participant takes back more premium than it puts in—where both assume the same amount of risk they put in—then there has been a transfer of wealth between the unrelated parties and one party has become a

loser in the transaction, even before insurance losses are accounted for. The benefit of a pool is not the opportunity to get back more premium than one puts in. The benefit is that the impact of a large loss is shared by all rather than by one.

The potential downside of entering a pooling arrangement is that one will have lower direct losses than others in the pool and will end up subsidizing their greater losses. In other words, the insured might pay more to cover its proportional share of other participants' losses than it would have paid to cover its own losses absent a pooling arrangement. But that potential upside or potential downside is a function of the outcome of the distributed risk, not of the exchange of premium. The amount of risk each participant puts into the pool and the amount of risk they take back must be the same in order for the pool to be fair.[12] Premium is merely a proxy for that risk. The economic consequence of upside or downside as a result of pool participation comes not from the exchange of premium, but rather from the ultimate loss experience associated with the shared risk.

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[12] There are arrangements where an insurer might cede risk to a pool and take back less risk than it ceded or not take back any risk at all. In those scenarios, the insurer is typically trying to manage, and in particular reduce, the magnitude of its risk. On the other hand, the insurer in *Reserve* and those in our examples intend to maintain the magnitude of their risk, but to reduce the volatility of that risk by distributing it. In other words, an insurer that wants to have less risk will cede that risk and not take any risk back, but an insurer that wants the same amount of risk will cede that risk and take back the same amount that was ceded in order to distribute its risk.

Quota share arrangements are simply percentage splits where the participants distribute the results of the pool in accordance with their relative proportions of premium. They are common in both commercial and captive insurance. *See, e.g.*, Rev. Rul. 78-338, 1978-2 C.B. 107 (1978); Rev. Rul. 80-120, 1980-1 C.B. 41 (1980); Rev. Rul. 2002-91, 2002-2 C.B. 991 (all ruling that group captive arrangements, which are analogous to quota share arrangements, were insurance for tax purposes). Under a quota share agreement, members of a syndicate, consortium, or pool agree to share risks in a proportionate amount. As explained in the recent paper authored by the Captive Insurance Companies Association and illustrated below in Charts A and B, a small syndicate may be only three members agreeing to split risks 50%/35%/15%,[13] while a large risk pool may have a thousand or more participants sharing risks in proportion between them.[14] By forming a syndicate or joining a risk pool and using a quota share arrangement, smaller insurers can diversify their risk and mix risks with similarly situated insurers, reducing the likelihood that a single large loss will bankrupt the insurer.

[13] *Id*. For illustrative purposes, the pool here has only 3 participants, but most pools have many more.

[14] *See Commonly Accepted Practices*, *supra* note 2.

Chart A: Premiums and Risk Transfer[15]

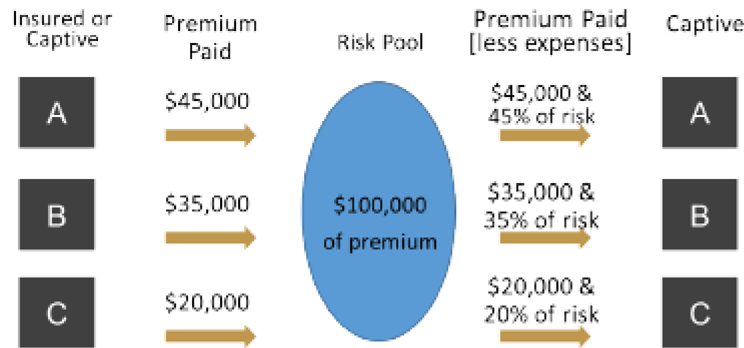

Chart B: Losses Incurred[16]

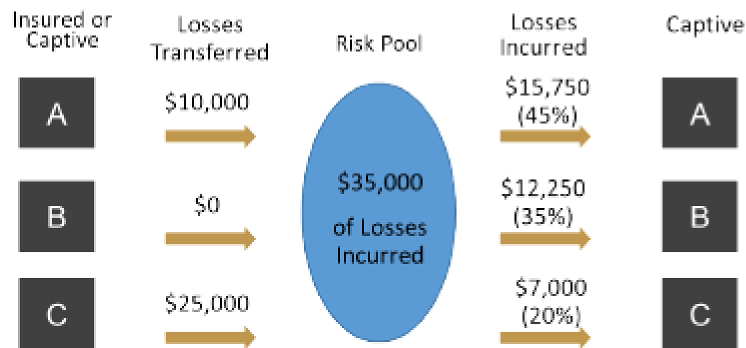

Chart A illustrates how each participant pays premium to the pool, and each participant's related captive receives the same amount from the pool. What is critical to understand and may not be evident from the illustration is that the risk and premium that end up in Captive A, for example, are not the same risk and premium that were put into the pool by Insured A. Instead, each captive receives risk and premium that are partly from its related participant and partly from each other participant, so that the risk and the premium are mixed and distributed

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[15] *Commonly Accepted Practices*, *supra* note 2.

[16] *Id.*

proportionately across all participants. The result can be seen in Chart B, where each captive bears its proportionate share of each loss, regardless of which captive incurred the loss. Pool participants will be obligated to pay their proportionate shares of the aggregate risk.[17]

The Tax Court erred in characterizing a risk pool as a circular flow of funds because there is no circular flow of funds in a risk pool. In a risk pool, each participant gets back the same amount of risk and premium as they put in, but the source of the risk and premium has changed materially. What goes into the pool is the participant's own risk and premium, and what comes out of the pool is the participant's proportionate share of each of the risks and associated premium that went into the pool.

CONCLUSION

Amici urge the Court to closely review the reasoning of the Tax Court and ensure its conformity with accepted and longstanding principles of insurance and tax law. The ten State organizations and SIIA filing this brief believe the Tax Court erred to the extent it:

> (1) required a policyholder to show a prior loss history for any line of coverage as a prerequisite for the arrangement to qualify as insurance for federal income tax purposes,

[17] *Id.*

(2) required an insurance policy to be individually manuscripted and negotiated to qualify as insurance for federal income tax purposes, and

(3) concluded that a risk pool fails to satisfy the requirements of *The Harper Insurance Group v. Comm'r* and the tax test of insurance and fails to provide sufficient risk distribution merely because the insurance premiums paid into the pool were identical in amount to the dollars ceded to ultimate insurers.

Dated: February 27, 2020

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This brief complies with the type-volume limitation of Rules 32(a)(7)(B) and 29(a)(5) of the Federal Rules of Appellate Procedure because it contains 6,481 words, excluding the parts of the brief exempted by Rule 32(f).

This brief complies with the typeface requirements of Rule 32(a)(5) of the Federal Rules of Appellate Procedure and the type-style requirements of Rule 32(a)(6) of the Federal Rules of Appellate Procedure because this brief has been prepared in a proportionally spaced typeface using 14-point Times New Roman font.

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I hereby certify that on February 27, 2020, I electronically filed the foregoing with the Clerk of the Court for the United States Court of Appeals for the Tenth Circuit by using the appellate CM/ECF system.

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