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

Petitioner,

ELECTRONICALLY FILED

v.

Docket No. 14545-16

COMMISSIONER OF INTERNAL REVENUE,

Respondent

PETITIONER'S MEMORANDUM RE: AVRAHAMI V. COMMISSIONER

UNITED STATES TAX COURT

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

ISSUES MEMORANDUM OF PETITIONER RE: AVRAHAMI V. COMMISSIONER

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TABLE OF AUTHORITIES

For the reasons discussed herein and in Petitioner's reply brief ("P-RBrf.")[1] at pages 70ff., Avrahami v. Comm'r, 149 T.C. No. 7 (Aug. 21, 2017), is inapposite.

In Avrahami, this Court held that (i) amounts the Avrahamis' companies paid as insurance premiums to Feedback, a company Mrs. Avrahami wholly-owned, were not deductible as business expenses for tax years 2009 and 2010, and (ii) Feedback did not qualify as an insurance company under § 831(b) based on this Court's finding of no risk distribution and no commonly accepted notions of insurance in Feedback's claimed insurance arrangements. Id. at 65, 75-76, 86-89.

In Avrahami, the Court focused on Feedback's claimed reinsurance[2] of Pan American's terrorism coverage and held that there was no risk distribution because Pan American was not an

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[1] Unless otherwise indicated, any capitalized terms used but not defined herein have the meanings assigned to such terms in Petitioner's brief ("P-Brf.") and P-RBrf., and any section references are to the Internal Revenue Code of 1986, as amended, and Treasury Regulations thereunder, as in effect for and applicable to the year(s) in issue, and all Rule references are to this Court's Rules of Practice and Procedure.

[2] Reinsurance is insurance, specifically, "'insurance of insurance companies.'" Fed. Ins. Office ("FIO"), U.S. Dep't of Treas., The Breadth and Scope of the Global Reinsurance Market and the Critical Role Such Market Plays in Supporting Insurance in the United States, p. 7 (Dec. 2014), available at https://www.treasury.gov/initiatives/fio/reports-and-notices/Documents/FIO%20-Reinsurance%20Report.pdf (citing Reinsurance Ass'n of Am., Fundamentals of P/C Reinsurance); see also Trans City Life Ins. Co. v. Comm'r, 106 T.C. 274, 278-79 (1996).

insurance company.[3] Id. at 75. The Avrahamis argued that risk distribution was present in Feedback's insurance arrangements as a result of Feedback's participation in a risk distribution program through Pan American, which only wrote terrorism coverage for insureds participating in the same program, one of which was American Findings, a company the Avrahamis owned. Id. at 3-6, 32, 33-35, 45, 68. For example, in 2009 and 2010, Pan American wrote terrorism coverage for American Findings, which in return paid a $360,000 premium for such coverage, and Pan American then reinsured or ceded a share of the pooled terrorism coverage to Feedback, which in return received a premium almost equal to the $360,000 premium American Findings had paid to Pan American. Id. at 34. Pan American replicated this arrangement (for differing premium amounts) with each of the program's other participating insureds and their affiliated insurance companies. Id. at 34-36, 67-68. The Court, however, rejected the Avrahamis' argument, finding, among other things, that:

> (i) the premiums for Pan American's terrorism coverage were excessive because they were set at a rate that the Court stated was more than 80 times the premium rate paid by one of the Avrahamis' companies for underlying terrorism coverage from an unrelated commercial insurer (id. at 70);

[3] In the case of reinsurance, Respondent has ruled that the existence of risk distribution is to be determined by looking through to the underlying risks that are reinsured. See Rev. Rul. 2009-26, 2009-38 I.R.B. 366. Here, this would mean evaluating the risks that Petitioner reinsured for the existence of risk distribution, not whether PoolRe was an insurance company (even though it was).

(ii) Pan American's terrorism coverage was very unlikely to respond to a loss event due to policy exclusions[4] (id. at 72); and

(iii) instead of being related to the risks that the terrorism coverage purportedly insured, the reinsurance premiums Feedback received approximated the amount of premium income that Feedback could receive and still remain under the then-applicable $1.2 million premium ceiling in § 831(b) for Feedback's underwriting income to be tax exempt (id. at 85).

The Court also held that Feedback's arrangements were not within the commonly accepted notions of insurance. Id. at 85-86. According to the Court, Pan American paid 97.5% of the premiums to the reinsurers by or before midway through the policy period and otherwise lacked sufficient funds from which to pay claims.[5] Id. at 35-36, 72-73, 75. As such, Pan American could not respond to a claim if the reinsurers did not pay the claim. Moreover, the Court noted that if Pan American were insolvent, the terrorism policies allowed claims to be paid with a promissory note, payable over a 3-year period. Id. at 39, 70. In addition, more than 65% of Feedback's assets were long-term unsecured loans made to an entity the Avrahamis' children owned,[6] with no

[4] The Avrahamis' actuary at trial conceded this point, the Court finding that he "did not know of any event in history that would have met" the requirements for Pan American's terrorism coverage. Id. at 72.

[5] Other than premiums receivable, the Court found the only assets reported on Pan American's income tax returns for 2009 and 2010 were cash of $200,000 and $390,000, respectively. Id. at 36.

[6] P-RBrf. at page 72 mis-identifies Belly Button's owners.

required interest payments for several years.[7] These loans were also untimely disclosed to regulators, in violation of the insurance domicile's regulations. Id. at 79-80. The Court also noted there were no claims made until after Respondent had begun his examination, and some of the claims were paid even though they were untimely made under the policies. Id. at 78-79, 85-86.

The Court also rejected the Avrahamis' evidence regarding premiums Feedback charged on its direct written policies, including the testimony of the Avrahamis' actuary, which the Court regarded as unclear and result-oriented. Id. at 38, 84-85. According to the Court, the actuary's calculations were "aimed not at actuarially sound decision-making but at justifying total premiums as close as possible to $1.2 million—the target—without going over." Id. at 85. In contrast and over the Avrahamis' objection, the Court found Respondent's expert's testimony to be credible, instructive and helpful. Id. at 62-64, 70-72. The Court also took issue with Mr. Avrahami's testimony that he would "freak out" if he lost money as a result of Feedback's

[7] The Avrahamis' children testified that they were unaware of and did not know that they owned Belly Button. Id. at 41. Feedback's records reflected it had made three unsecured loans to Belly Button: (i) $830,000 in 2008 due and payable in 2018; (ii) $1.5 million in 2010 due and payable in 2020; and (iii) $200,000 in 2010 due and payable no earlier than 2012. Id. at 41-44, 79-80, 90-97. Belly Button immediately transferred these amounts to the Avrahamis either as loans or as the repayment of loans that the Avrahamis had made to Belly Button. Id. The Avrahamis conceded that the $200,000 loan was in fact a dividend, even though it was documented as a loan. Id. at 89.

participation in the quota share reinsurance arrangement with Pan American. Id. at 37, n.33, 73.

Here, a review of the record plainly shows that Petitioner's insurance arrangements do not present the same issues as those in Avrahami. Petitioner was created for a legitimate purpose and complied with all Anguilla regulatory requirements. PRFF 151. Substantial evidence supports the premiums that were charged, and Respondent presented no contrary evidence. PRFF 110-128. Petitioner's reinsurance arrangements are fully supported by the evidence. PRFF 81-95, 97; Rev. PRFF 96A-B.[8] Petitioner paid claims under both the direct written policies and the reinsurance arrangements, and did not do so with promissory notes. PRFF 98-104. Petitioner did not make any loans. Entire record. Respondent issued 39 favorable tax-exempt determinations to insurance companies with insurance arrangements similar to Petitioner's. PRFF 155-160. Multiple experts also testified that Petitioner's insurance arrangements constituted insurance from accounting, insurance industry and regulatory perspectives. PRFF 170-173. These experts directly addressed the pooling or risk distribution effects under these insurance arrangements. Exs. 97-P, 103-P; Ex. 104-P, pp. 3-4, 11-12, 14-19, 26-28, Figs. 1-3; Exs. 114-P, 130-P; see also Ex.

[8] The $5.039 million referenced in Revised PRFF 96A should be corrected to $5.627 million. Ex. 51-J, pp. RSV-4141-4142.

96-J.[9] Dr. Doherty further opined that the level of risk distribution present here "sail" past the standard set forth in Harper, a case in which he also testified. Ex. 104-P, pp. 14-17. He also testified that such risk pooling arrangements are normal insurance industry arrangements and commonly used as a means of diversifying risk.[10] Ex. 104-P, pp. 3-4, 11-12, 14-19, 26-28, Figs. 1-3; Tr. 255:25-266:15. Under the reinsurance arrangements, PoolRe maintained millions of dollars in liquid funds to pay claims until after the policies' 6-month extended reporting periods and the final accounting and settlement of any claims were completed.[11] Rev. PRFF 96A-B.

Despite having issued 39 rulings approving small captive insurance arrangements just like Petitioner's, Respondent's position now (without explanation) is that no small captive insurance company qualifies under § 501(c)(15). This "one size

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[9] In addition to the expert testimony, Mr. Snyder, writing for Myron Steves, an insurance firm, stated in a letter to PoolRe that "[t]he stop loss structure is one alternative, a reasonable one, in our view, to limiting the liability of the 'primary' insurer, and assuring the insured of a source of funds to pay losses which may be in excess of the amounts the primary insurer desires to retain." Ex. 96-J, p. 2, ¶ 1. Mr. Snyder further concluded that the premium retained by PoolRe and the quota share premium(s) ceded to the participating captives were reasonable. Id., p. 2, ¶ 5; see also Ex. 95-J.

[10] See also FIO source cited supra note 2, at pp. 13-17.

[11] Petitioner's portion of the amounts retained by PoolRe are further reflected in Petitioner's general ledgers and financial statements. See citations to Rev. PRFF 96A; see e.g., Ex. 30-P, p. 4 (listing entries for "A/R Q/S Retention - PoolRe"): see also Ex. 124-P.

fits all" position, however, ignores (i) the substantial evidence in the record supporting the validity of Petitioner's insurance arrangements, including the extensive testimony of Petitioner's highly-qualified experts (unlike the baseless opinions of Respondent's expert, which even Respondent appears to have abandoned);[12] (ii) Respondent's approval of other pooling arrangements, including those like Petitioner's; and (iii) the almost century-old statutes in the Code providing for such tax-exempt treatment (see Avrahami, 149 T.C. No. 7 at 50-52).

As discussed above, the Court in Avrahami stated that the quota share agreements provided for a "circular flow of cash." Id. at 67-68, 75. These comments, however, should not be taken out of the context of the facts in Avrahami. The Court found that the insurance premiums "paid" for "terrorism coverage" were

[12] Moreover, Respondent, instead tries to assign fault for not producing evidence that he did not even bother to ask about during the trial, that he now thinks, without any support, that Petitioner should have presented. For example, Respondent claims that Petitioner should have produced extensive evidence concerning all of the insurance policies for which risks were pooled and subject to the PoolRe Quota Share Reinsurance Arrangement and the tens of thousands of risks reinsured under the CreditRe Reinsurance Arrangement. See Resp. Reply Brf. at pp. 34, 40-41, 50-51. In doing so, Respondent, yet again, reveals his misunderstanding of the reinsurance arrangements at issue, which are all treaty reinsurance arrangements. Ex. 104-P, pp. 15-16. While the type of "due diligence" that Respondent describes might be seen with respect to a facultative reinsurance arrangement, such is not the case for a "treaty" reinsurance arrangement, which is the more common form used, as it is less labor intensive and costly to place and administer. See FIO source cited supra note 2, at pp. 7-10.

not insurance premiums; thus, there was cash paid by the insured entity to Pan American that was not for insurance that was then routed to Feedback. As a result, there is no insurance-related explanation for this cash flow from one related entity to another. This does not mean, however, that pooling or quota share reinsurance arrangements are invalid as a matter of law. To be sure, Respondent has explicitly approved the use of pooling or quota share reinsurance arrangements as a means of spreading, distributing or blending risk in circumstances in which an insured's premium approximated the reinsurance premium ceded to an associated captive. PLR 201219011 (May 11, 2012) and PLR 201224018 (June 15, 2012); PRFF 152-156, 158, 160; cf. § 6110(k)(3) (rulings not precedential); but see Transco Exploration Co. v. Comm'r, 949 F.2d 837 (5th Cir. 1992). Moreover, the Treasury Department has commented favorably on risk pooling arrangements similar to those utilized here.[13]

Before this Court issued Avrahami, Respondent made no "circular flow of funds" argument,[14] let alone with respect to the PoolRe Quota Share Reinsurance Arrangement, which he mainly

[13] See FIO source cited supra note 2, at p. 13 (describing pooling arrangements).

[14] Even a cursory review of Respondent's Pre-trial Memorandum and opening brief and his expert's report and testimony shows this to be the case. The closest Respondent came to any such argument was in connection with Petitioner's payment on Peak's 2009 Stillwater Loss. See R-Brf. at pp. 57-58.

attacked for Petitioner's alleged failure to prove that it had paid reinsurance premiums to PoolRe. R-Brf. at pp. 46-47, 73ff.[15] He presented no evidence (in the form of expert testimony or otherwise) to support any such argument. See Exs. 136-R, 137-R; entire record. After Avrahami, however, Respondent shifted his position to allege the "circular flow of funds" argument in his reply brief ("R-RBrf."). See, e.g., R-RBrf. at pp. 9-10, 11, 13, 27-29, 38-39, 47-49. But Petitioner simply does not fit the Avrahami mold.

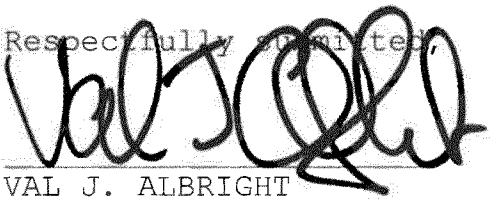
As Petitioner has repeatedly explained, Petitioner received, and did not pay, reinsurance premiums. See e.g., P-RBrf. at pp. 66ff.; PRFF 85, 88-89. Respondent either is ignoring or does not understand the evidence. As discussed above, the record unequivocally shows Petitioner's reinsurance arrangements, including the PoolRe Quota Share Reinsurance Arrangement, were real and were consistent with the commonly accepted notions of insurance. PoolRe received stop loss premiums in return for insurance coverage under many insurance policies that PoolRe and the other pool participants jointly underwrote covering many different types of risks, which were

[15] Respondent's argument with respect to the CreditRe Reinsurance Arrangement centered on Petitioner's alleged failure to put into evidence the underlying vehicle service contacts and show Petitioner received reinsurance premiums for that arrangement, not on whether such arrangement was a sham or resulted in a circular flow of funds. In fact, Respondent even conceded that such arrangement distributed some amount of risk. Id. at 74-75.

then pooled or blended and reinsured by each of the insurance companies participating in the pooling arrangement. PRFF 88-95, 97; Rev. PRFF 96A-B. This is not an impermissible circular flow of funds. Avrahami 149 T.C. No. 7 at 67-68, 75; Rent-A-Center, Inc. v. Comm'r, 142 T.C. 1, 11-12 (2014).

Here, Respondent raises new issues, not because they are present in this case, but simply because they were present in Avrahami. Avrahami, however, is inapposite and does nothing to address the lack of merit in Respondent's position. Petitioner is an insurance company for Federal income tax purposes and is exempt from tax under § 501(c)(15).

Respectfully submitted,



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