No. 18-9011

In The United States Court Of Appeals
For The Tenth Circuit

RESERVE MECHANICAL CORP.,
Petitioner-Appellant,
v.
COMMISSIONER OF INTERNAL REVENUE,
Respondent-Appellee.

On Appeal from the Decision of the United States Tax Court
Docket No. 14545-16, Hon. Kathleen Kerrigan

**OPENING BRIEF OF PETITIONER-APPELLANT
RESERVE MECHANICAL CORP.**

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ORAL ARGUMENT REQUESTED

Corporate Disclosure Statement

Pursuant to Federal Rule of Appellate Procedure 26.1(a), Petitioner-Appellant Reserve Mechanical Corp. states that (1) no publicly-held corporation owns 10% or more of its stock, and (2) its parent company is Peak Casualty Holdings, LLC, a Nevada limited liability company.

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Statement of Prior or Related Cases

Pursuant to Tenth Circuit Rule 28.2(C)(1), Petitioner-Appellant states that there are no prior or related cases.

Glossary of Acronyms

Pursuant to Tenth Circuit Rule 28.2(C)(6), the following is a glossary of acronyms used in this brief:

"Capstone" means Capstone Associated Services, Ltd.

"CreditRe" means Credit Reassurance Corporation.

"Commissioner" means the Commissioner of Internal Revenue.

"EPA" means U.S. Environmental Protective Agency.

"FDAP income" means fixed or determinable annual or periodical income.

"Lyndon" means Lyndon Property Insurance Company.

"MEL" means Mining Equipment Ltd.

"Mid-Continent" means Mid-Continent General Agency, Inc.

"Peak" means Peak Mechanical & Components, Inc.

"Peak Casualty" means Peak Casualty Holdings, LLC.

"PoolRe" means PoolRe Insurance Corp.

"Reserve" means Petitioner-Appellant Reserve Mechanical Corp.

"RocQuest" means Rocquest, LLC.

"Willis" means Willis HRH of Houston (n.k.a. Willis Towers Watson).

"ZW" means ZW Enterprises, LLC.

Glossary of Insurance Terms

For the Court's convenience, the following is a glossary of insurance terms used in this brief:

"Direct-written insurance" is insurance issued directly to the insured policyholder describing what kinds of liability will be covered and at what dollar limits.

"Facultative reinsurance" is a type of reinsurance that entails a reinsurer assuming specific risks instead of an entire class of risks under a reinsurance agreement (facultative contract). The facultative reinsurer assesses the unique characteristics of each risk to determine whether to reinsure the risk, and at what price, thus retaining the faculty, or option, to accept or reject any risk.

"Follow the fortunes" is a doctrine of treaty reinsurance, sometimes confirmed in a clause ("follow the fortunes" clause), that the reinsurer accepts the underwriting judgment of the reinsured and shares its underwriting fortunes.

"Fronting arrangement" is an arrangement in which policies are issued by a direct insurer that serves as a "front" or "fronting company" for a reinsurer that reinsures 100% of the risks.

"Quota share reinsurance" is a type of treaty reinsurance in which the ceding insurer transfers, and the reinsurer accepts, a given percentage of both the premium charged for the underlying insurance policy and the exposure thereunder to first-dollar losses such that the ceding insurer and the reinsurer share proportionately in all premiums and losses.

"Reinsurance" is insurance of contractual liabilities to pay claims incurred under contracts of direct-written insurance or reinsurance. Reinsurance occurs when one insurer (the cedent, ceding insurer or reinsured) transfers (cedes) all or part of the risk it underwrites, pursuant to a policy or group of policies, to another insurer (the reinsurer).

"Retrocession agreement" is a reinsurance agreement in which a reinsurer (the retrocedent) transfers (retrocedes) its position on reinsurance to another reinsurer (the retrocessionaire).

"Risk-pooling" is a form of diversification that reduces the dispersion or volatility of losses and is the essence of insurance. Through a joint underwriting operation (the risk pool), insurers or reinsurers accept fixed percentages of all business underwritten, either by one or more of them or by an independent manager.

"Stop loss coverage" is coverage that protects against large claims by reimbursing some portion of losses exceeding a predetermined amount.

"Treaty reinsurance" is a type of reinsurance that entails a reinsurer accepting a percentage participation in all risks of a certain type or class underwritten by the primary insurer (or another reinsurer) during a specified period of time. Once the reinsurance agreement (treaty) is written, the reinsured cedes an entire block of business to the treaty reinsurer who is automatically bound to accept all of the policies under the block of business, including unwritten ones.

Introduction and Overview

This case arises from a company's need for specialized insurance coverage that was not available on the commercial market. Peak Mechanical & Components, Inc. ("Peak") is in the business of manufacturing, selling, and servicing heavy machinery used in underground mining operations. Peak is located 200 feet from the Coeur d'Alene River in the heavily polluted Bunker Hill Superfund site in the mountains of northern Idaho.

Peak's operations include cleaning used mining equipment, a hazardous process that produces dangerous contaminants. CERCLA (a.k.a. "Superfund") requires Peak to prevent any release of those toxic substances. *See* 42 U.S.C. § 9601, *et seq*. While Peak had never caused an accidental contamination, its owners were concerned that an error in its cleaning operations could leak contaminants into the river, causing massive environmental liability. Peak sought but could not find a commercial insurance policy that would cover either its pollution risk or multiple other risks Peak faced.

Peak's solution was to form its own captive insurance company—Petitioner-Appellant Reserve Mechanical Corp. ("Reserve")—to provide the needed coverage. With the assistance of consultants, actuaries, and other insurance industry experts, Reserve issued direct-written policies insuring Peak and two affiliates against pollution liability and other risks.

Like Peak, many companies whose operations present unusual or potentially catastrophic risks have formed captive insurers. Recognizing this business necessity and to make such insurers financially viable, Congress exempted from taxation income earned by "insurance companies" whose gross receipts do not exceed $600,000. 26 U.S.C. ("I.R.C." or the "Code") § 501(c)(15).

While Reserve was under the income threshold, the tax court held that Reserve did not qualify for the exemption because its transactions did not constitute insurance for tax purposes. Caselaw generally holds that an arrangement constitutes insurance for tax purposes if (1) the arrangement involves insurable risks, (2) the arrangement shifts the risk of loss to the insurer, (3) the insurer distributes the risk among its policyholders, and (4) the arrangement is insurance in the commonly accepted sense.

App.Vol.3.p.882.[1] The central issue in this appeal is whether the tax court erred in holding that Reserve's transactions did not constitute insurance based on the court's determination that Reserve failed parts (3) and (4) of the four-part test.

As to part (3) of the test—risk distribution—courts have repeatedly recognized that a captive insurer sufficiently spreads risk so as to constitute risk distribution if at least 30% of its gross premiums are derived from covering risks of unrelated insureds. Reserve met this test by receiving more than 30% of its gross premiums from reinsuring pooled and blended risks of more than 150 insureds under more than 500 direct-written policies jointly issued by PoolRe Insurance Corp. ("PoolRe") and more than fifty captive insurers, and from reinsuring risks relating to a large pool of policies for vehicle service contracts. The tax court, however, rejected this conclusion, holding that Reserve's reinsurance arrangements did not allow Reserve to effectively distribute risk because the arrangements were with

[1] "App." refers to Reserve's Appendix, which is cited herein by volume and page number.

PoolRe, an unrelated entity that the court concluded was not a "bona fide insurance company."

It is apparent from the tax court's opinion that it viewed Reserve, PoolRe, and the insurance arrangements at issue with skepticism, but the court's criticisms are groundless. For example, the court objected that Peak did not have "a genuine need" for pollution liability insurance because Peak had operated continuously for ten years without incurring costs for pollution liability. App.Vol.4.p.906, 909. This flawed reasoning is akin to saying that automobile insurance is unnecessary for drivers who have not yet had an accident.

Reserve's direct-written policies provided real insurance: when Peak suffered a covered loss and made a claim, Reserve paid. Reserve's risk-distributing arrangements imposed real contractual rights and obligations. If Peak suffered a large covered loss, a substantial portion of the loss over a predetermined amount would be borne by the fifty-plus insurers participating in the risk pool. By the same token, if one of those insurers responded to a large loss, Reserve would also be called upon to pay its proportionate share of the loss.

This Court's decision will be the first decision by any circuit court to analyze key issues with respect to a captive insurer's risk distribution through reinsurance arrangements and participation in a risk pool. Instructive caselaw in this area from other jurisdictions is very limited, so this Court's decision is likely to have a major impact on the insurance industry as a whole. Congress enacted the tax exemption for captive insurance companies to encourage their formation, but the tax court's rejection of Reserve's exempt status would frustrate legislative intent by unreasonably restricting the number and kind of captive insurers that could qualify. As shown below, the tax court's holdings were erroneous as a matter of law and should be reversed.

Jurisdictional Statement

The tax court had jurisdiction pursuant to I.R.C. §§ 6213, 6214, and 7442. This is an appeal from the tax court's Memorandum Findings of Fact and Opinion filed on June 18, 2018, and its decision entered on September 28, 2018. App.Vol.3.p.850-Vol.4.p.915, 1003. Reserve timely filed its notice of appeal on December 20, 2018. App.Vol.4.p.1004. *See* Tax Ct. R. 190; Fed. R. App. P. 13, 14; 10th Cir. R. 14. This Court has jurisdiction pursuant to I.R.C. §§ 7482(a)(1) and 7483.

Statement of the Issues Presented for Review

1. The tax court held that Reserve's transactions did not constitute insurance for tax purposes because they did not allow Reserve to effectively distribute risk and were not insurance in the commonly accepted sense.

(a) Did the court err in concluding that Reserve did not effectively distribute risk through its participation in a reinsurance risk pool and coinsurance arrangement because PoolRe, an unrelated entity that managed the risk pool and ceded risks to Reserve, was not a bona fide insurance company?

(b) In determining that Reserve's transactions were not insurance in the commonly accepted sense, did the court err in relying on a patently incorrect reading of Reserve's direct-written policies as providing only excess coverage and on a series of unfounded assumptions about the nature of the insurance business in general and captive insurance in particular?

2. Having concluded that Reserve's transactions did not constitute insurance for tax purposes and Reserve therefore was not an insurance company exempt from tax under I.R.C. § 501(c)(15), the court held that

Reserve was ineligible to make an election under I.R.C. § 953(d) to be treated as a domestic corporation and imposed the 30% withholding tax under I.R.C. § 881(a) on Reserve's gross receipts for the tax years in issue. As an alternative issue:

(a) Did the court err in holding that the payments Reserve received as insurance premiums were taxable income, instead of nontaxable capital contributions to Reserve, where the court's rationale was that there was no legitimate business purpose for the payments?

Statement of the Case

I. Factual Background

A. Description of Insurance, Reinsurance and Captive Insurance.

Insurance is a financial arrangement in which contributions of multiple parties, each exposed to the possibility of loss, are used to compensate those that actually suffer loss. App.Vol.13.p.3704. In the insurance industry, direct-written insurance and reinsurance play different roles. The former is insurance issued directly to the insured policyholder describing what kinds of liability will be covered and at what dollar limits. *See N. River Ins. Co. v. CIGNA Reinsurance Co.*, 52 F.3d 1194, 1198 (3d Cir.

1995). The latter is insurance of contractual liabilities to pay claims incurred under contracts of direct-written insurance or reinsurance. 1 Robert L. Carter, *Carter on Reinsurance* 4 (5th ed. 2013); *see also* Graydon S. Staring & Hon. Dean Hansell, *Law of Reinsurance* § 1:1 (2019 ed.).

Reinsurance occurs when one insurer (the cedent, ceding insurer or reinsured) transfers (cedes) all or part of the risk it underwrites, pursuant to a policy or group of policies, to another insurer (the reinsurer). *Unigard Sec. Ins. Co., Inc. v. N. River Ins. Co.*, 4 F.3d 1049, 1053 (2d Cir. 1993). In typical reinsurance transactions, after a primary insurer first underwrites risks in exchange for premiums from the insureds, the primary insurer transfers (cedes) a portion of its risks to one or more reinsurers, who accept the risks in exchange for premiums from the primary insurer. *Delta Holdings, Inc. v. Nat'l Distillers & Chem. Corp.*, 945 F.2d 1226, 1229 (2d Cir. 1991). In this way, the primary insurer is able to further spread the risks it has underwritten. *Id.* A reinsurer (the retrocedent), in turn, may transfer (retrocede) its position on reinsurance to another reinsurer (the retrocessionaire) through a "retrocession agreement." *Id.*; *Trans City Life Ins. Co. v. Comm'r*, 106 T.C. 274, 278-79 (1996).

"The purpose of reinsurance is to diversify the risk of loss and to reduce required capital reserves." *Unigard,* 4 F.3d at 1053. Reinsured risk is spread in layers with premium dollars allocated in greater amounts to those who have taken larger risks. *N. River*, 52 F.3d at 1199 n.4. "Spreading part of the risk to the reinsurer can prevent a catastrophic loss from falling upon the insurance company and enable the insurance company to serve more clients." *Emp'rs Reinsurance Corp. v. Mid-Continent Cas. Co.*, 358 F.3d 757, 761 (10th Cir. 2004).

There are two basic types of reinsurance contracts—facultative and treaty. *N. River*, 52 F.3d at 1199. Facultative reinsurance entails a reinsurer assuming specific risks instead of an entire class of risks under a reinsurance agreement (facultative contract). *Delta Holdings,* 945 F.2d at 1229. The facultative reinsurer assesses the unique characteristics of each risk to determine whether to reinsure the risk, and at what price, thus '"retain[ing] the faculty, or option, to accept or reject any risk.'" *N. River*, 52 F.3d at 1199 (citation omitted).

In contrast, treaty reinsurance entails a reinsurer accepting "a percentage participation in all risks of a certain type or class underwritten by the primary insurer (or another reinsurer) during a specified period of time." *Delta Holdings*, 945 F.2d at 1229; *see also Unigard*, 4 F.3d at 1054 ("A 'typical treaty reinsurance agreement might reinsure losses incurred on all policies issued by the ceding insurer to a particular insured, while facultative reinsurance would be limited to the insured's losses under a policy or policies specifically identified in the reinsurance agreement.'" (citation omitted)). Once the reinsurance agreement (treaty) is written, the reinsured cedes an entire block of business to the treaty reinsurer who is automatically bound to accept all of the policies under the block of business, including unwritten ones. *N. River*, 52 F.3d at 1199. Importantly, "[b]ecause a treaty reinsurer accepts an entire block of business, it does not assess the individual risks being reinsured; rather, it evaluates the overall risk pool." *Id.* Typically, this type of reinsurance agreement also includes a "follow the fortunes" clause. *Id.* "Follow the fortunes" refers to a doctrine of treaty reinsurance that the reinsurer accepts the underwriting judgment of the reinsured and shares its underwriting fortunes. Staring & Hansell, *supra*, § 2.10; *N. River*, 52 F.3d at 1199. That doctrine is sometimes confirmed in a clause ("follow the fortunes" clause) that obligates the reinsurer to indemnify the reinsured for any good faith payment of an insured loss, thereby preventing the reinsurer from second-guessing good-faith settlements and obtaining de novo review of judgments of the reinsured's liability to its insured. *Id.*

Captive insurance is a form of alternative risk management financing that can be used to accomplish several objectives including, *inter alia*, filling-in gaps in coverage and enabling the captive's insured operating business(es) to insure risks that are either too costly or otherwise unavailable in the commercial marketplace. App.Vol.7.p.2036; *see also* *Ocean Drilling & Exploration Co. v. United States*, 988 F.2d 1135, 1138 (Fed. Cir. 1993); *Crawford Fitting Co. v. United States*, 606 F. Supp. 136, 147 (N.D. Ohio 1985); *Securitas Holdings, Inc. v. Comm'r*, 108 T.C.M. (CCH) 490, at *3 (2014); *Rent-A-Center, Inc. v. Comm'r*, 142 T.C. 1, 3-4 (2014).

B. Peak's Need for Captive Insurance Arises.

Peak manufactures, custom-designs, distributes, sells, repairs, and services equipment used in mining, including in deep underground mines in Idaho's Silver Valley. App.Vol.2.p.370-71, Vol.4.p.1120. Peak's affiliate, RocQuest, LLC ("RocQuest"), owns and leases the real estate and facilities where Peak bases its operations in Silver Valley, within the Bunker Hill Superfund site. App.Vol.4.p.1116-20, Vol.5.p.1386. This site contains toxic mine tailings and other poisons left by unsafe mining practices that yielded silver, lead, and zinc for over 100 years. App.Vol.4.p.1116-21.

Underground mining poses occupational hazards of accidental death and serious injury. App.Vol.4.p.1117-20. Norman Zumbaum and Corey Weikel, Peak's owners, knew many miners who had died on the job, including Weikel's father. App.Vol.4.p.1117-19. Weikel was once buried up to his neck by falling rock, causing such severe injuries that doctors thought he would never walk again. App.Vol.4.p.1119-20. In a separate incident, a large stage winch that Zumbaum's and Weikel's former employer, Mining Equipment Ltd. ("MEL")—a business similar to Peak—had supplied to a customer, plummeted down a vertical shaft, killing a worker and resulting in a lawsuit against MEL, which settled for $1 to $2 million. App.Vol.4.p.1118.

Peak's equipment was used in mines in Silver Valley, which remains an active Superfund site. App.Vol.4.p.1119-22. Peak's submersible pumps extracted groundwater to prevent flooding. App.Vol.4.p.1121-22. Its large ventilation fans vented noxious gases and cooled underground temperatures that otherwise would have reached 150 degrees. App.Vol.4.p.1119. Its hydraulically-operated steel doors directed the flow of air. App.Vol.4.p.1122. Its specially-designed and custom-built trucks hauled explosives, fuel, and miners in tunnels thousands of feet underground. App.Vol.4.p.1121-22.

Mud lining the mine floor harbors toxic pollutants like lead, zinc and the powerful explosive, ammonium nitrate. App.Vol.4.p.1122. This toxic soup contaminates Peak's equipment, requiring rehabilitation and cleaning at Peak's facility, which lies in a floodplain about 200 feet from the already-contaminated Coeur d'Alene River. App.Vol.4.p.1120-36. Peak also had to control and store this toxic soup at Peak's facility with cleaning bays, pumps and containment areas until it could be treated and hauled off for disposal. App.Vol.4.p.1122. An accident in Peak's cleaning and containment operations could have led to further contamination and possible environmental liability for Peak and its owners and customers. App.Vol.4.p.1122-23; *see also* 42 U.S.C. § 9607 (regarding CERCLA liability).

As part of its risk-management program, Peak attempted unsuccessfully to acquire commercial pollution liability insurance. App.Vol.4.p.1124. Peak also faced other risks, including possible large financial losses when mines in Silver Valley shut down in the 2000s due to the U.S. Environmental Protective Agency's ("EPA") accelerated cleanup efforts and when regulatory changes created unforeseen liabilities. App.Vol.4.p.1135-36. Further, Peak's relationship with its commercial insurer soured over the handling of a claim where the insurer took six months before offering an inadequate sum for Peak's loss. App.Vol.4.p.1123-24, 1132-38. In response to these events, and acting on a mentor's recommendation, Peak explored forming a captive insurance company. App.Vol.4.p.1124.

Peak contacted industry expert Capstone Associated Services, Ltd. ("Capstone") to assess the feasibility of forming a captive insurance company. App.Vol.4.p.1124-25, Vol.5.p.1206-07, 1372-74. Capstone performed a feasibility study, which included, *inter alia*, an on-site inspection of Peak's facilities, assessment of existing insurance coverages, and evaluation of risks and risk management needs. App.Vol.4.p.1124-25, Vol.5.p.1206-07, 1385-86, 1415. The feasibility study recommended that Peak form a captive because the commercial policies in place left several coverage gaps for risks Peak faced and such coverage was either too costly or otherwise unavailable in the commercial marketplace. App.Vol.7.p.2027-95. One of the world's largest insurance consulting firms, Willis HRH of Houston (n.k.a. Willis Towers Watson) ("Willis"), worked with Capstone to finalize and issue the study. App.Vol.4.p.1077-79, Vol.5.p.1374, 1385-86.

After reviewing a draft of the feasibility study, in 2008, Peak's owners decided to form Reserve as a captive insurer under the laws of the British Overseas Territory of Anguilla, one of the world's largest captive domiciles. App.Vol.4.p.1125, 1133, Vol.5.p.1248, 1254. During the tax years in issue, Anguilla licensed and regulated Reserve as an insurer. App.Vol.5.p.1434-35, Vol.7.p.1885-87. Peak Casualty Holdings, LLC ("Peak Casualty"), a Nevada limited liability company owned by Zumbaum and Weikel, owned 100% of Reserve's stock. App.Vol.2.p.366.

C. Reserve Issues Policies, Collects Premiums, and Distributes Risk.

During the tax years in issue, Reserve issued between eleven and thirteen direct-written policies per year to Peak and its affiliates, ZW Enterprises, LLC ("ZW"), a lending company, and RocQuest (collectively, the "Direct Insureds"). These direct-written policies provided primary coverages (i.e., they did not duplicate the limited commercial insurance coverages the Direct Insureds maintained) that the feasibility study had identified for addressing Peak's risks. App.Vol.7.p.2031-32, 2047-50, Vol.12.p.3570-71, 3586-87. These coverages slightly differed from year-to-year but generally included: (1) pollution liability; (2) product recall; (3) punitive wrap; (4) employment practices liability; (5) loss of services; (6) weather-related business interruption; (7) loss of major customer; (8) legal expense reimbursement; (9) expense reimbursement; (10) director and officer liability; (11) regulatory changes; (12) intellectual property; (13) tax liability; and (14) cyber risk. App.Vol.11.p.3106-3249, 3283-Vol.12.p.3388, 3421-3521.

Capstone administered Reserve on a day-to-day basis, a standard practice in the captive insurance industry. App.Vol.7.p.1830. Mid-Continent General Agency, Inc. ("Mid-Continent"), an unaffiliated Lloyd's of London underwriter, worked with Capstone to price the risks and set the premiums Reserve charged the Direct Insureds. App.Vol.5.p.1236-37. At trial, two fully-credentialed, independent actuaries testified that they endorsed the premiums Reserve charged as "actuarially sound" and "reasonable." App.Vol.13.p.3779-865, 3885-Vol.18.p.5327.

During each tax year in issue, for coverage under the direct-written policies, the Direct Insureds paid approximately 80% of the premiums to Reserve and the remainder to another insurer, PoolRe, which jointly underwrote Reserve's policies pursuant to joint underwriting stop loss endorsements. App.Vol.11.p.3270-77, Vol.12.p.3411-20, 3545-51. These contracts implemented a common insurance practice of layering risk using stop loss coverage. App.Vol.4.p.1194-95, Vol.13.p.3712-13, 3724. "Stop loss coverage" protects against large claims by reimbursing some portion of losses exceeding a predetermined amount. *See Reich v. Lancaster*, 55 F.3d 1034, 1041 n.4 (5th Cir. 1995). Under these contracts, PoolRe (the stop loss insurer) participated with Reserve (the lead insurer) in an intermediate loss layer above a loss threshold borne solely by Reserve. App.Vol.4.p.1191-95, Vol.13.p.3712-13, 3724 ; *see also* Addendum A (Diagram A) (using 2010 as an exemplar year).

PoolRe operated as a licensed insurer in the British Virgin Islands before redomiciling to Anguilla in 2009. App.Vol.4.p.1085, Vol.11.p.3278-82. While PoolRe was administered by Capstone, it was not a captive insurer of Reserve or the Direct Insureds and did not share any common owners, directors, officers, or other key employees with them. App.Vol.5.p.1424. PoolRe was also not related to the other captive insurers that Capstone administered and their affiliated insureds. App.Vol.4.p.1065, Vol.5.p.1424, 1465-66.

As it did with Reserve and for the Direct Insureds, PoolRe jointly underwrote direct-written policies with numerous unrelated captive insurers and provided stop loss coverage for unrelated insureds. App.Vol.4.p.1191, Vol.13.p.3712-3715. In this way, PoolRe assumed a portfolio of higher-layer losses, leaving the smaller losses with the captive insurers. *Id*.

PoolRe also managed a reinsurance risk pool. App.Vol.11.p.3256, 3276, Vol.12.p.3396, 3527, 3562. A risk pool is a joint underwriting operation in which insurers or reinsurers accept fixed percentages of all business underwritten, either by one or more of them or by an independent manager. Staring & Hansell, *supra*, § 2.10. "Risk-pooling is a form of diversification that reduces the dispersion or volatility of losses and is the essence of insurance." *Delta Holdings*, 945 F.2d at 1229. Risk-pooling is commonly used in the insurance industry to distribute or spread risk. App.Vol.4.p.1081, Vol.13.p.3708. During each tax year in issue, Reserve and more than fifty other captive insurers that Capstone administered participated in the PoolRe risk pool by means of quota share reinsurance arrangements. App.Vol.13.p.3713; *see also* Addendum B (Diagram B) (using 2010 as an exemplar year). Notably, the Commissioner had reviewed and approved of PoolRe's risk pool as a reinsurance mechanism no less than 39 times before the tax years in issue. App.Vol.19.p.5497-593.

"Quota share reinsurance" is treaty reinsurance under which the ceding insurer transfers, and the reinsurer accepts, a given percentage of both the premium charged for the underlying insurance policy and the exposure thereunder to first-dollar losses such that the ceding insurer and the reinsurer share proportionately in all premiums and losses. Carter, *supra*, at 147. For example, in the case of a 20% quota share, the insurer transfers 20% of its liability and premiums on every risk to the reinsurer, who must pay 20% of any loss sustained, whether total or partial. *Id.* The percentage is constant throughout and applies to premiums and losses alike. *Id.*

Under these arrangements, PoolRe ceded out from the risk pool all of the risks it underwrote pursuant to the joint underwriting stop loss endorsements, thereby reinsuring the pooled risks with all of the pool participants on a proportional (quota share) basis, and those participants agreed to pay their respective proportionate share of the PoolRe losses. App.Vol.13.p.3712-15. All of the participating captive insurers thus shared a percentage of the risks PoolRe underwrote, and in return, received an equivalent share of the stop loss premiums. Vol.4.p.1191-94, Vol.5.p.1427-29, 1467-68, Vol.11.p.3258-59, Vol.12.p.3398-99, 3527, 3530-31, Vol.13.p.3712-15. All of the participating captive insurers also had to "follow the fortunes" of PoolRe and thus were bound by any payments PoolRe made to the insureds on the direct-written policies in the risk pool. App.Vol.11.p.3253, Vol.12.p.3392, 3525.

As Diagram B in the addendum depicts (using 2010 as an exemplar year), Reserve participated in the risk pool by reinsuring its quota share of the blended risks that PoolRe pooled. *See* App.Vol.9.p.2470, Vol.18.p.5383. Because the risks in the pool originated from risks of more than 150 insureds under more than 500 direct-written policies jointly issued by PoolRe and more than fifty captive insurers, the pool of blended risks was highly diversified. App.Vol.4.p.1193-95, Vol.5.p.1416-29, Vol.13.p.3712-15, 3741-57. Thus, although the amount of pooled and blended risks each pool participant assumed under the quota share arrangements equaled the amount of risks PoolRe assumed from providing stop loss coverage to each participant's respective affiliated insureds, the nature of those risks differed. App.Vol.4.p.1193-94, Vol.5.p.1427-29, 1467-68. Instead of insuring only affiliated insureds, each participating captive insurer was able to distribute its overall risk among hundreds of unrelated policyholders. App.Vol.5.1416, Vol.13.p.3712-17.

Likewise, although the amount of quota share premiums that each participating captive insurer received under the quota share arrangements equaled the amount of stop loss premiums PoolRe received from each participant's respective affiliated insureds, the nature of the funds differed. App.Vol.5.p.1429. Once the risk pool received the stop loss premiums, those commingled funds lost their identities and the original insureds lost their right to control the use of those fungible funds. App.Vol.5.p.1467; *Weber Paper v. United States*, 204 F. Supp. 394, 399-400 (W.D. Mo. 1962), *aff'd*, 320 F.2d 199 (8th Cir. 1963). Thus, although their amounts were the same, the makeup of the stop loss premiums that PoolRe received and the makeup of the quota share premiums that PoolRe paid did not match. App.Vol.4.p.1193-94. Notably, the Commissioner has issued numerous private letter rulings approving of similar arrangements where the quota share premiums from the reinsurance pool were equivalent in dollar terms to the amount ceded to the pool by the insurer in the first instance.[2] *E.g.*, I.R.S. P.L.R. 200907006 (Feb. 13, 2009); I.R.S. P.L.R. 200950016 (Dec. 11, 2009); I.R.S. P.L.R. 201030014 (July 30, 2010); I.R.S. P.L.R. 201219009 (May 11, 2012); I.R.S. P.L.R. 201219011 (May 11, 2012); I.R.S. P.L.R. 201224018 (June 15, 2012).

During the tax years in issue, Capstone and Mid-Continent calculated the stop loss premiums that the insureds paid to PoolRe and the quota share premiums that PoolRe paid to the captive insurers participating in the risk pool using actuarial methods and objective criteria. App.Vol.5.p.1239-42, Vol.11.p.2350-60, 3250-60, Vol.12.p.3389-3400, 3522-33, 3560-69. In addition, the premium allocations under the quota share arrangements were based on, *inter alia*, the input and advice of Myron Steves & Co. (for 2008 and 2009), a large insurance brokerage, and Glicksman Consulting, LLC (for 2010), an accredited actuarial consulting firm. App.Vol.12.p.3562-69.

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[2] Although lacking in precedential value, these rulings reflect how the Commissioner interprets, administers and applies the tax laws. I.R.C. § 6110(k)(3); *cf. Hanover Bank v. Comm'r*, 369 U.S. 672, 686-87 (1962).

In addition to reinsuring unrelated risks that PoolRe ceded from its risk pool, Reserve and PoolRe executed retrocession agreements under which Reserve reinsured on a coinsurance basis unrelated risks from insurance policies that PoolRe itself had reinsured under a treaty dated June 1, 2000 between PoolRe and Credit Reassurance Corporation, Ltd. ("CreditRe"),[3] a Nevis Island corporation that was merged into Credit Reassurance, Ltd. on January 1, 2009. App.Vol.11.p.3261-69, Vol.12.p.3401-10, 3534-44, 3713. The risks that Reserve reinsured each year under this arrangement were the insurance exposures for that year on all policies of vehicle service contracts directly written by Lyndon Property Insurance Company ("Lyndon") in force on January 1, 2006 and subsequently issued, and assumed by CreditRe from Aria (SAC) Ltd., under its treaty dated January 1, 2006. *Id.* Thus, during each tax year in issue, the risks that Reserve reinsured under this arrangement and the coinsurance premiums Reserve received originated from thousands of individual policyholders to

[3] CreditRe shared no common ownership with PoolRe or any of the captive insurers Capstone administered. App.Vol.5.p.1284. Nor was CreditRe a captive insurance company or administered by Capstone. App.Vol.5.p.1424.

whom Lyndon, a U.S.-based insurance company, had issued policies, and were ceded from Lyndon to intervening unrelated reinsurers, including CreditRe and PoolRe, before ultimately being reinsured by Reserve. *Id.*

During each tax year, the quota share and coinsurance premiums Reserve received totaled more than 30% of Reserve's gross premiums. App.Vol.9.p.2467, Vol.13.p.3713-14, Vol.18.p.5380. Because more than 30% of Reserve's gross premiums was derived from Reserve's unrelated insurance business (i.e., insurance outside Reserve's captive insurance arrangement with its sister companies, the Direct Insureds), one of Reserve's experts, Dr. Neil A. Doherty, an accomplished recognized insurance expert who also testified in *Harper Group v. Commissioner*, 96 T.C. 45 (1991), *aff'd*, 979 F.2d 1341 (9th Cir. 1992), opined that Reserve had achieved a very considerable degree of risk distribution that exceeded the 30% threshold recognized by the tax court in *Harper*. App.Vol.13.p.3716-17, 3725. Dr. Doherty further opined that, during each of the tax years in issue, based on his review of the quota share and coinsurance arrangements, Reserve's direct-written policies, and the policies underwritten by the other captive insurers participating in the PoolRe risk pool,[4] (1) the policies insured insurable risks, (2) the risks were shifted, (3) the risks were distributed, (4) the arrangements were insurance as it is commonly understood, and (5) Reserve was an insurance company. App.Vol.4.p.1190-94, Vol.13.p.3713-26.

D. Reserve Pays Losses for Covered Claims.

During each tax year in issue, Reserve paid covered claims, including one large claim by Peak in 2009 under Reserve's loss-of-major-customer policy totaling $339,820. App.Vol.2.p.377-78, Vol.4.p.1127-29, Vol.12.p.3552-59. Reserve also paid $186,892 in losses under the coinsurance program ($61,160, $70,332, and $56,400 in 2008, 2009, and 2010, respectively). App.Vol.9.p.2478, 2490-91, 2504, Vol.19.p.5416.

II. Procedural History

For the tax years in issue, Reserve met the gross-receipts requirement of $600,000 set by I.R.C. § 501(c)(15), filed federal income tax returns on

[4] The risk pool consisted of more than 500 policies during each tax year in issue and provided a diverse array of coverages. App.Vol.4.p.1193-94, Vol.5.p.1416, Vol.9.p.2470, Vol.13.p.3714, 3741-57.

Form 990 under I.R.C. § 501(c)(15), and elected to be taxed as a domestic taxpayer under I.R.C. § 953(d). App.Vol.1.p.42, 78.

In a notice of deficiency, the Commissioner determined that Reserve owed income taxes totaling $144,538, $164,418, and $168,305 for 2008, 2009, and 2010, respectively. App.Vol.6.p.1589-95. The Commissioner determined that Reserve did not qualify as an insurance company for tax purposes under I.R.C. § 501(c)(15) and alleged that Reserve's insurance and reinsurance arrangements lacked economic substance. App.Vol.6.p.1592. Reserve petitioned the tax court to redetermine the deficiencies. App.Vol.1.p.1-21.

After trial and briefing, the tax court issued its opinion in favor of the Commissioner, holding that Reserve was not an insurance company for tax purposes and imposing a 30% tax on Reserve's gross receipts. App.Vol.3.p.850-Vol.4.p.915. This appeal followed. App.Vol.4.p.1003-04. The Commissioner did not cross-appeal.

III. Rulings Presented for Review

Reserve challenges the following rulings of the tax court:

1. That Reserve was not an insurance company for tax purposes.

2. That the payments Reserve received as insurance premiums were taxable income, instead of nontaxable capital contributions. App.Vol.3.p.896, Vol.4.p.911, 915.

Summary of Argument

As to both rulings, the tax court misapplied controlling legal principles.

Risk distribution: The tax court erred in holding that, despite the uncontroverted fact that over 30% of Reserve's gross premiums for each of the tax years in issue was derived from providing insurance to unrelated parties through its reinsurance arrangements, Reserve did not distribute risk through these arrangements. The court based its holding that Reserve did not distribute risk on its legal conclusion that PoolRe was not a "bona fide insurance company." The existence of a bona fide insurance company, however, is not necessary for risk distribution to exist. Indeed, tax law recognizes "insurance" even where *no insurance company exists*. Moreover, the court misapplied the legal test for risk distribution by focusing on PoolRe, instead of Reserve, and requiring PoolRe be a bona fide insurance company for Reserve to be able to distribute risk through its arrangements with PoolRe. Had the court correctly applied the legal test for risk distribution, the only reasonable conclusion it could have reached under the undisputed facts is that Reserve distributed risk as a matter of law.

Insurance in the Commonly Accepted Sense: The tax court further erred in holding that Reserve's transactions were not insurance in the commonly accepted sense. The court's holding is premised on a patently incorrect reading of Reserve's direct-written policies as providing only excess coverage, and a series of unfounded assumptions about the nature of the insurance business in general and captive insurance in particular. These errors led the court to erroneously hold that Reserve's transactions did not constitute insurance in the commonly accepted sense.

Contributions to Capital: Alternatively, if the tax court correctly determined that Reserve was not an insurance company for tax purposes, the court erred in holding that the payments Reserve received as insurance premiums were taxable income, instead of nontaxable capital contributions to Reserve. Where, as here, the court's rationale for its decision was that there was no legitimate business purpose for the payments, the only viable alternative tax characterization of the payments Reserve received is that they were nontaxable capital contributions.

Argument

I. Standard of Review

This Court reviews the tax court's findings of fact for clear error and conclusions of law de novo. *Estate of Holl v. Comm'r*, 967 F.2d 1437, 1438 (10th Cir. 1992). This Court also reviews de novo "the standards and tests governing the factual analysis, and the application of the law to the facts," *Shellito v. Comm'r*, 437 F. App'x 665, 669 (10th Cir. 2011) (unpublished), and "is not bound by the clearly erroneous standard when the trial court has based its findings on an erroneous view of the law," *Valley Improvement Ass'n v. U.S. Fid. & Guar. Corp.*, 129 F.3d 1108, 1123 (10th Cir. 1997). The general characterization of a transaction for tax purposes is a question of law. *Frank Lyon Co. v. United States*, 435 U.S. 561, 581 n.16 (1978).

II. The Tax Court Erred in Holding that Reserve's Transactions Did Not Constitute Insurance for Tax Purposes.

An "insurance company" is tax-exempt if its gross receipts for the taxable year do not exceed $600,000, and more than half of those receipts consist of insurance premiums. I.R.C. § 501(c)(15). An entity is an "insurance company" if more than half of its business during the taxable year is the issuing of insurance or reinsurance contracts. *Id.* § 816(a). Reserve's gross receipts did not exceed $600,000 for any tax year in issue, and substantially all of those receipts came from the kinds of transactions at issue here. The central issue in this appeal is whether those transactions constituted "insurance." If so, Reserve was an insurance company for tax purposes and tax-exempt under I.R.C. § 501(c)(15).

Whether a transaction constitutes insurance is a question of law reviewed de novo. *E.g., AMERCO, Inc. v. Comm'r*, 979 F.2d 162, 164 (9th Cir. 1992). While the Code does not define "insurance" or "insurance company," caselaw generally looks to four criteria in deciding whether an arrangement constitutes insurance for tax purposes: (1) the arrangement involves insurable risks; (2) the arrangement shifts the risk of loss to the insurer; (3) the insurer distributes the risks among its policyholders; and (4) the arrangement is insurance in the commonly accepted sense. *Helvering v. Le Gierse*, 312 U.S. 531, 539-40 (1941); *Rent-A-Center*, 142 T.C. at 13.

For captive insurers like Reserve, before proceeding to the four-part test to analyze whether the captive insurer's transactions constituted insurance, courts conduct a threshold inquiry to determine whether the captive insurer is a sham. *Malone & Hyde v. Comm'r*, 62 F.3d 835, 840 (6th Cir. 1995) ("We believe the tax court put the cart before the horse in this case. It should have determined first whether Malone & Hyde [the parent] created Eastland [the captive insurance subsidiary] for a legitimate business purpose or whether the captive was in fact a sham corporation."). If the captive insurer is a sham, i.e., it was not created for a legitimate business purpose, its separate taxable treatment is disregarded. *Moline Props., Inc. v. Comm'r*, 319 U.S. 436, 438-39 (1943); *Ocean Drilling*, 988 F.2d at 1144, 1150. A captive insurer that is a sham cannot be a bona fide insurance company. *Rent-A-Center*, 142 T.C. at 10 ("[O]ur initial inquiry is whether Legacy was a bona fide insurance company. We respect the separate taxable treatment of a captive unless there is a finding of sham or lack of business purpose.").

Here, the tax court did not undertake this threshold sham analysis to determine whether Reserve was created for a legitimate business purpose or was in fact a sham. This analytical decision became centrally important later in the court's analysis because it *did* perform a sham analysis—but of the wrong entity—PoolRe. Instead of proceeding with the threshold sham analysis, the court proceeded directly to the four-part test to analyze whether Reserve's transactions constitute insurance. The court ultimately held that those transactions did not constitute insurance for tax purposes because they did not pass muster under parts (3) and (4)—risk distribution and insurance in the commonly accepted sense. *See* App.Vol.3.p.896, Vol.4.p.911. The court's analysis of both factors, however, misapplied controlling legal principles, thereby leading to reversible error.

A. The Tax Court Erroneously Held that Reserve Did Not Distribute Risk.

1. How Courts Define Risk Distribution.

In *Le Gierse*, the Supreme Court, addressing the meaning of the term "insurance" under the federal estate tax laws, stated that historically and commonly insurance involves risk-distributing, 312 U.S. at 539-40, but did not define "risk-distributing," leaving lower courts to develop their own interpretations of the term, *Ocean Drilling*, 988 F.2d at 1144. For its part, this Court has defined "risk-distributing" as follows: "'risk distributing' means that the party assuming the risk distributes his potential liability, in part, among others." *Beech Aircraft Corp. v. United States*, 797 F.2d 920, 922 (10th Cir. 1986). This Court, however, has not squarely discussed the issue of risk distribution in the captive insurance context. Rather, in the two occasions that captive insurance issues have come before this Court, both were disposed of on other grounds, without analyzing risk distribution. *Id.*

at 922-23 (disposing of case based on risk-shifting); *Stearns-Roger Corp. v. United States*, 774 F.2d 414, 415 (10th Cir. 1985) (same). Those cases are thus not instructive here, and this Court must look to decisions of other courts for guidance.

Like this Court, other courts have defined risk distribution as "spreading the risk of loss among policyholders." *E.g., Ocean Drilling*, 988 F.2d at 1153. Courts have held that "[r]isk distribution occurs when an insurer pools a large enough collection of unrelated risks (i.e., risks that are generally unaffected by the same event or circumstance)." *Rent-A-Center*, 142 T.C. at 24. "[A]s 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 & Co. v. Comm'r*, 972 F.2d 858, 863 (7th Cir. 1992). The pooling transforms and diminishes risk. *Id.* The pooling of exposures thus brings about the risk distribution. *Securitas*, 108 T.C.M. (CCH) 490, at *10. "Distributing risk allows the 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 the claim." *R.V.I. Guar. Co. v. Comm'r*, 145 T.C. 209, 228 (2015).

Here, the tax court held that Reserve's transactions did not constitute insurance because they did not allow Reserve to effectively distribute risk. The court's holding was premised on its legal conclusion that PoolRe was not a bona fide insurance company. This Court reviews de novo the tax court's legal conclusions and the legal standard the tax court applied in reaching its conclusions. *See Shellito*, 437 F. App'x at 669; *AMERCO*, 979 F.2d at 164; *James v. Comm'r*, 899 F.2d 905, 909 (10th Cir. 1990).

In evaluating risk distribution, courts look at *the actions of the insurer*—not the insured—because it is the *insurer's risk* that is reduced by risk distribution. *Rent-A-Center*, 142 T.C. at 24. Because "risk-distribution looks at the transaction from the standpoint of the insurer," *AMERCO*, 979 F.2d at 169, "[t]he focus is broader and looks more to the insurer as to whether the risk insured against can be distributed over a larger group rather than the relationship between the insurer and any single insured." *Humana, Inc. v. Comm'r*, 881 F.2d 247, 256 (6th Cir. 1989).

While the arrangements at issue here concern reinsurance rather than direct insurance, the focus of the risk distribution analysis remains the same. *See, e.g., Ocean Drilling*, 988 F.2d at 1153 n.25 ("Direct insurance and reinsurance are both considered insurance."). Even the Commissioner agrees that "[c]ourts have generally analogized reinsurance to insurance." Rev. Rul. 2009-26, 2009-38 I.R.B. 366. Thus, risk distribution, in either context, is analyzed in the same manner, i.e., from the insurer's perspective and by looking solely to the pool of risks assumed by the insurer. *See Humana*, 881 F.2d at 256-57; *Sears*, 972 F.2d at 861. Accordingly, as the Commissioner himself acknowledges, in the context of captive insurance, courts have looked through a fronting arrangement to the pool of risks a captive reinsured in analyzing whether risk distribution exists. Rev. Rul. 2009-26, 2009-38 I.R.B. 366. A "fronting arrangement" is a well-established and accepted arrangement in which policies are issued by a direct insurer that serves as a "front" or "fronting company" for a reinsurer that reinsures 100% of the risks. Staring & Hansell, *supra*, § 2.10 (defining "fronting contract" as "a reinsurance of 100 percent, in which the direct insurer is a 'front' for the reinsurer."); *see also Reliance Ins. Co. v. Shriver, Inc.*, 224 F.3d 641, 643 (7th Cir. 2000).

In *Harper,* the tax court considered the percentage of the captive insurer's gross premiums that was derived from unrelated insurance business for purposes of analyzing risk distribution and determined that the captive insurer had "a sufficient pool of insureds to provide risk distribution" when approximately 30% of its business came from insuring unrelated parties. 96 T.C. at 59-60. Reserve exceeded the *Harper* threshold for risk distribution, receiving more than 30% of its gross premiums was derived from Reserve's unrelated insurance business through its quota share and coinsurance arrangements. App.Vol.3.p.885-87, Vol.13.p.3716-18, 3725-26.

2. The Tax Court Misapplied the Legal Test for Risk Distribution, Relying on *Avrahami* Instead.

In analyzing whether Reserve distributed risk, the tax court failed to apply the well-established precedents set forth just above. Relying instead on *Avrahami v. Commissioner*, 149 T.C. 144 (2017), the court stated that "[i]n cases where we held that the captive insurer achieved risk distribution by insuring a sufficient number of unrelated parties, we also determined that the transactions with the unrelated parties were insurance transactions for Federal income tax purposes." App.Vol.3.p.887. According to the court, this meant that "before we can determine whether Reserve effectively distributed risk through these agreements, *we must determine whether PoolRe was a bona fide insurance company*." *Id.* (emphasis added). The court then set out *Avrahami's* multi-part test for a bona fide insurance company, concluded that PoolRe did not qualify, and held that Reserve's reinsurance arrangements with PoolRe did not allow Reserve to effectively distribute risk. App.Vol.3.p.887-97.

In relying on *Avrahami*, the tax court misapplied the legal test for analyzing risk distribution and committed error, which this Court reviews de novo. *See Shellito*, 437 F. App'x at 669; *AMERCO*, 979 F.2d at 164.

i. Risk distribution does not require the existence of a bona fide insurance company.

Before *Avrahami*, no court had held that a captive insurer can achieve risk distribution by reinsuring an unrelated party *only if* the unrelated party itself is a bona fide insurance company. Even the authorities on which *Avrahami* relied in fashioning this novel approach lend no support. *Harper* based risk distribution on the percentage of gross premiums paid by unrelated insureds versus the percentage paid by related companies; risk distribution occurred where the unrelated premiums ranged from 29% to 33% of the captive insurer's total business. 979 F.2d at 1342. In *AMERCO*, 52% to 74% sufficed to achieve risk distribution. 979 F.2d at 164. And in *Rent-A-Center*, the captive insurer assumed and pooled only premiums of affiliates for "a sufficient number of statistically independent risks" and achieved risk distribution because it issued policies for its affiliates that covered more than 14,000 employees, 7,100 vehicles and 2,600 stores in all 50 States. 142 T.C. at 24. None of the foregoing cases involved a captive insurer that acted as a reinsurer.

The reason why *Avrahami* stands alone is apparent: the existence of a bona fide insurance company is not necessary for risk distribution to exist. To the contrary, *Avrahami*'s approach to risk distribution conflicts with well-established caselaw recognizing insurance for federal tax purposes even where *no insurance company exists*.[5] *E.g., Ross v. Odom*, 401 F.2d 464, 465-70 (5th Cir. 1968); *Comm'r v. Treganowan*, 183 F.2d 288, 290-91 (2d Cir. 1950).

Treganowan is particularly illustrative. In that case, pursuant to the New York Stock Exchange's ("NYSE") constitution, NYSE members made an initial payment to a death-benefit fund and again contributed that same amount when any member died. 183 F.2d at 289-90. In addition to these

[5] Notably, the Commissioner's lone expert agreed that insurance requires little formality, testifying that an "insurance contract" arises regardless of (1) the premium's amount, (2) actuarially determined premiums, or (3) any premium payment at all. App.Vol.4.p.1492-93.

pooled payments, the NYSE allocated one-half its profits over $10,000 to the fund. *Id.* These two sums, along with excess payments and accumulated interest, made up the NYSE's "gratuity fund," from which the fund's trustees paid a member's estate a substantial death benefit. *Id.*

The Second Circuit held that the arrangement at issue not only shifted "the risk of loss from premature death" to the other members of the NYSE, but it also *manifestly distributed risk*. *Id.* at 291. According to the court, "[r]isk distribution ... emphasizes the broader, social aspect of insurance as a method of dispelling the danger of a potential loss by spreading its costs throughout a group," and because of this arrangement, "the risk of premature death is borne by the 1373 other members of the [NYSE], rather than by the individual." *Id.* "By diffusing the risks through a mass of separate risk shifting contracts, the insurer cast his lot with the law of averages. The process of risk distribution, therefore, is the very essence of insurance." *Id.* (citation and internal quotation marks omitted). Given its substance, the arrangement qualified as insurance. The fact that the NYSE was not an insurance company did not affect the court's conclusion that the arrangement was insurance, let alone the court's analysis of whether the arrangement distributed risk.[6]

Similarly, in *Ross*, the Fifth Circuit, citing *Treganowan*, recognized that insurance can arise in the absence of an insurance company in holding that a death benefit paid by the State of Georgia to a state employee's beneficiary "constituted proceeds of 'a life insurance contract' under [I.R.C.] § 101(a)(1) and were thus wholly tax exempt." 401 F.2d at 465-67. The Fifth Circuit further recognized that insurance can arise even in the absence of an insurance contract. *Id.* at 467-68 (stating that the insurance agreement need not be in the form of the standard life insurance contract or in the form of a contract at all). Rather, according to the Fifth Circuit, insurance "historically" turns on "the presence in a binding arrangement of

[6] *Treganowan* is a seminal case on insurance for tax purposes and risk distribution in particular and has been approvingly cited as authority by numerous circuit courts, including this Court, *see, e.g., Beech Aircraft*, 797 F.2d at 922; *Ross*, 401 F.2d at 467; *Clougherty Packing Co. v. Comm'r*, 811 F.2d 1297, 1300 (9th Cir. 1987); the tax court, *see, e.g., R.V.I. Guar.*, 145 T.C. at 232; *Avrahami*, 149 T.C. at 193; and the Commissioner in his rulings addressing risk distribution, *see, e.g.,* Rev. Rul. 2005-40, 2005-2 C.B. 4; Rev. Rul. 2009-26, 2009-38 I.R.B. 366; Rev. Rul. 2008-8, 2008-1 C.B. 340.

risk-shifting and risk distribution," both of which existed in *Ross*, even though no insurance company or insurance contract existed. *Id.*

In recognizing insurance, *Treganowan* and *Ross* focused not on a transaction's form, but on its economic realities because, as the Fifth Circuit noted, looking through form to substance is the cornerstone of sound taxation, for tax law deals in economic realities, not legal abstractions. *Ross*, 401 F.2d at 468; *see also Haynes v. United States*, 353 U.S. 81, 83-85 (1957); *Weinert's Estate v. Comm'r*, 294 F.2d 750, 755 (5th Cir. 1961); *cf. Epmeier v. United States*, 199 F.2d 508, 511 (7th Cir. 1952) ("[T]here is no legal magic in form; the essence of the arrangement must determine its legal character.").

Unlike the well-established caselaw emphasizing the importance of adhering to this fundamental principle, *Avrahami* ignored it. Even more troubling, however, is that *Avrahami*'s approach to risk distribution would produce contradictory and untenable results depending on whether the insurance recognized in these cases was reinsured by a captive insurer, like Reserve. For example, if Reserve reinsured the insurance recognized in *Treganowan* and more than 30% of Reserve's gross premiums were from such unrelated business, the risk distribution analysis would not end there.

Rather, according to *Avrahami*, before the Court could determine whether Reserve distributed risk through such reinsurance, the Court must first decide if the NYSE itself is a bona fide insurance company because, if it is not, the insurance recognized in *Treganowan* would no longer be insurance for tax purposes and Reserve's reinsurance of same would not distribute risk. As such, because the NYSE is not a bona fide insurance company, Reserve's reinsurance of the insurance recognized in *Treganowan* would not be recognized as insurance for tax purposes. *Avrahami*'s approach to risk distribution is fundamentally flawed, and the tax court erred as a matter of law by adopting and applying that approach here.

ii. The tax court erroneously focused its risk distribution analysis on PoolRe, instead of Reserve.

Because risk distribution is analyzed from the perspective of the insurer, the tax court should have focused on Reserve, as "the party assuming the risk." *See Humana*, 881 F.2d at 256; *Rent-A-Center*, 142 T.C. at 24. Instead, relying on *Avrahami*, the court focused on PoolRe and thereby misapplied the legal test for risk distribution and disregarded the rationale for the risk distribution test itself. App.Vol.3.p.887-88. Compounding this error, the tax court, again relying on *Avrahami*, subjected PoolRe to a multi-part test to determine whether PoolRe was a bona fide insurance company. *Id.*

Neither here nor in *Avrahami* did the tax court explain its approach. Nor can any explanation be found in *Rent-A-Center*, from which *Avrahami* purportedly adopted this novel approach, including the "bona fide insurance company" nomenclature. In fact, *Rent-A-Center* did not discuss this test in connection with risk distribution or a reinsurance arrangement at all. Rather, *Rent-A-Center* considered it while conducting the ordinary threshold inquiry in captive insurance tax cases: whether the separate corporate existence of the captive insurance company should be respected for tax purposes or should be disregarded as a sham. 142 T.C. at 10. *Rent-A-Center* described this threshold issue as whether Legacy, the captive insurer involved in that case, was a "bona fide insurance company." *Id.* The tax court conducted no such inquiry here as to Reserve.

It is beyond dispute that PoolRe was owned and controlled by an unrelated individual and thus was not a captive insurer with respect to Reserve or the Direct Insureds. App.Vol.5.p.1424. Rather, PoolRe was an independent entity that entered into binding agreements imposing genuine obligations with, at minimum, Reserve and the Direct Insureds, the other captive insurers participating in the risk pool and their affiliated insureds, and CreditRe. App.Vol.11.p.3250-77, Vol.12.p.3389-410, 3522-51, 3713. These agreements were inherently arm's-length agreements because the contracting parties were unrelated. *See United Parcel Serv. of Am., Inc. v. Comm'r*, 254 F.3d 1014, 1018 (11th Cir. 2001) ("The kind of "economic effects" required to entitle a transaction to respect in taxation include the creation of genuine obligations enforceable by an unrelated party.").

It is also beyond dispute that, as part of Reserve's reinsurance arrangements, both of which were *treaty* arrangements, Reserve was bound to *automatically* accept all of the policies and losses covered thereby and thus would not have examined risks, investigated claims, or even received notices of losses from the original insureds. App.Vol.5.p.1428-29, Vol.11.p.3250-60, Vol.12.p.3389-400, 3522-33. The tax court's criticism of Reserve for not providing evidence of the existence of the thousands of vehicle service contracts reinsured under the coinsurance arrangements and the "industries, locations, operations, types of risks and exposure to risk" of all the "other Capstone entities" in the quota share arrangements, App.Vol.3.p.891, is thus misplaced and ignores not only the evidence in the record but also the rationale behind treaty reinsurance. App.Vol.4.1190-94, Vol.9.p.2470, Vol.13.p.3713-26. Indeed, if a reinsurer were required to duplicate the costly but necessary efforts of a primary insurer in evaluating risks and handling claims, reinsurance simply would not work because it would not be economical to place and administer. *Unigard*, 4 F.3d at 1054.

There is no precedent for focusing on PoolRe, instead of Reserve, let alone for focusing on whether PoolRe, instead of Reserve, is a bona fide insurance company in evaluating whether Reserve achieved risk distribution by insuring a sufficient number of unrelated parties.[7] To the contrary, the caselaw dictates that, in evaluating whether a transaction between two companies resulted in risk shifting and risk distributing, the entities must be considered as separate entities. *E.g., Ocean Drilling*, 988 F.2d at 1151 ("This court must adhere to the principles of *Le Gierse* and

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[7] Because *Avrahami* was issued after the evidence closed, neither party below geared its trial strategy for addressing risk distribution on establishing whether PoolRe was a bona fide insurance company. *Avrahami* was issued *after* the parties submitted their simultaneous opening briefs, and while the parties submitted limited briefing to the tax court regarding the impact, if any, of *Avrahami*, the evidence was not re-opened. In its limited briefing to the tax court, Reserve explained the reasons why *Avrahami* was factually and legally inapposite. Reserve further argued that evaluating whether Reserve distributed risk through its reinsurance arrangements with PoolRe did not require evaluating whether PoolRe was an insurance company. App.Vol.3.p.813-24.

Moline Properties in reaching a decision. Plaintiff and Mentor must be considered as separate entities in evaluating whether the transactions between the two companies resulted in risk shifting and risk distributing.").

3. When analyzed under the correct legal test, the undisputed facts show that Reserve distributed risk as a matter of law.

Due to the quota share and coinsurance premiums that Reserve received under its reinsurance arrangements, more than 30% of its gross premiums received during each tax year in issue was derived from Reserve's unrelated insurance business (i.e., insurance outside Reserve's captive insurance arrangement with its sister companies, the Direct Insureds). App.Vol.9.p.2467, Vol.13.p.3713-14, Vol.18.p.5380. Reserve thus exceeded the *Harper* threshold for risk distribution. Had the tax court here correctly applied the legal test for risk distribution, the only reasonable conclusion it could have reached under the undisputed facts is that Reserve distributed risk as a matter of law.

B. The Tax Court Erroneously Held that Reserve's Transactions Were Not Insurance in the Commonly Accepted Sense.

As an alternative ground for its holding that Reserve's transactions did not constitute insurance for tax purposes, the tax court determined that

Reserve's transactions were not insurance in the commonly accepted sense after analyzing whether (1) Reserve was organized, regulated and operated as an insurance company, (2) Reserve was adequately capitalized, (3) Reserve's policies were valid and binding, (4) Reserve's premiums were reasonable and negotiated at arm's length, and (5) Reserve paid claims. *See, e.g.*, *Rent-A-Center*, 142 T.C. at 24. While the court found parts (2) and (5) in Reserve's favor and part (3) as a neutral factor, the tax court held that Reserve failed parts (1) and (4) of this test, concluding that Reserve charged unreasonable premiums and was not operated like an insurance company.

In concluding that Reserve failed parts (1) and (4), the tax court relied on a patently incorrect reading of Reserve's direct-written policies. Reserve's policies provided *primary* coverage whenever no other policy covered the loss, which, for Reserve's Direct Insureds, was always the case. The court misread the policies, however, as providing only *excess* insurance—i.e., insurance that applies only after coverage afforded by one or more primary policies is exhausted. The court also relied on a series of unfounded assumptions about the nature of the insurance business in general and captive insurance in particular. As shown below, these errors led the tax court to erroneously hold that Reserve's transactions did not constitute insurance in the commonly accepted sense.

1. The Tax Court Misread Reserve's Direct-Written Policies as Providing Only Excess Coverage.

The interpretation of the terms of insurance policies, like other contracts, is a question of law that this Court reviews de novo, under applicable law. *Level 3 Commc'ns, LLC v. Liebert Corp.*, 535 F.3d 1146, 1154 (10th Cir. 2008); *Valley Improvement*, 129 F.3d at 1115. Reserve's direct-written policies designated Texas law as the law governing their interpretation. App.Vol.19.p.5681, 5696.

The tax court misinterpreted Reserve's insurance policies as providing *excess* insurance coverage rather than *primary* coverage based on its reading of the "other insurance" clauses of Reserve's direct-written policies. App.Vol.3.p.863, Vol.4.p.909, Vol.20.p.5703-04, 5730. Under a primary policy, Reserve's liability as an insurer attaches as soon as a covered loss occurs. *Nat'l Union Fire Ins. Co. v. Ins. Co. of N. Am.*, 955 S.W.2d 120, 138 (Tex. App.—Houston [14th Dist.] 1997, pet. denied), *aff'd sub nom. Keck, Mahin & Cate v. Nat'l Union Fire Ins. Co. of Pittsburgh, Pa.*, 20 S.W.3d 692 (Tex. 2000). An excess policy, on the other hand, makes the excess carrier liable for amounts above and beyond that which an insured may collect on primary insurance. *Id.* Given this layered coverage, an insured must exhaust the primary policy's coverage to trigger the excess policy. *Id.*

The tax court based this misunderstanding on its reading of the first paragraph of a two-paragraph "other insurance" clause, specifically:

> THE COVERAGES AFFORDED BY THIS POLICY ARE EXCESS OVER ANY OTHER VALID AND COLLECTIBLE INSURANCE POLICY ISSUED BY ANY OTHER INSURER * * *. THE LIMITS AND DEDUCTIBLES STATED HEREIN ONLY APPLY AFTER COVERAGE IS EXHAUSTED FROM ANY AND ALL OTHER VALID INSURANCE POLICIES ISSUED BY ANY OTHER INSURER.

App.Vol.3.p.863. Making matters worse, the tax court ignored the language in the second paragraph entirely, focusing instead on the first paragraph only. In doing so, the tax court impermissibly isolated a single section of the policy from the whole, thereby taking the "other insurance" clause out of context. *See RSUI Indem. Co. v. The Lynd Co.*, 466 S.W.3d 113, 118 (Tex. 2015). The operative word "collectible" vanishes from the text. *Id.*

The second paragraph (i.e., the one not cited by the tax court) states:

> THIS EXCESS POLICY DOES NOT REQUIRE THE INSURED TO MAINTAIN ANY SPECIFIC UNDERLYING PRIMARY INSURANCE POLICIES UNLESS SPECIFIED BY ENDORSEMENT TO THIS POLICY. ***THE COVERAGES AFFORDED HEREIN WILL DROP DOWN AND PROVIDE PRIMARY COVERAGE ONLY IF THERE ARE NO OTHER VALID AND COLLECTIBLE INSURANCE POLICIES IN FORCE TO WHICH A CLAIM WOULD APPLY***.

E.g., App.Vol.20.p.5703-04, 5730 (emphasis added). Reading the first paragraph with the second, i.e., taking the "other insurance" clause as a whole, makes the plain meaning of the clause clear. When read as a whole, it is obvious that Reserve's policies provide primary coverage when no other valid and collectible insurance policies cover *the same claim*.

To classify Reserve's policies as primary rather than excess accords with Texas law governing "other insurance" clauses. The "type of loss" itself, not the "other insurance" clause, determines whether a policy affords primary or excess coverage. *Soc'y of Prof'ls in Dispute Resolution, Inc. v. Mt. Airy Ins. Co.*, Civ. Action No. 3:97–CV–0071–D, 1997 WL 711446, at *3 (N.D. Tex. Nov. 7, 1997) (unpublished). Moreover, the mere presence of another policy does not trigger the "other insurance" clause in Reserve's policies. *United Nat'l Ins. Co. v. Mundell Terminal Servs., Inc.*, 740 F.3d 1022, 1028-31 (5th Cir. 2014); *Mt. Airy Ins.*, 1997 WL 711446, at *3. "Under Texas law, the provisions of an 'other insurance' clause apply only when the 'other' insurance covers the same property and interest therein against the same risk in favor of the same party." *Mundell Terminal Servs.*, 740 F.3d at 1028 (omitting quotation).

None of Peak's commercial insurance policies covered the same risk of loss as Reserve's direct-written policies did. App.Vol.12.p.3570-88. Where, as here, Peak's commercial insurance policies and Reserve's policies covered different risks, the "other insurance" clause in Reserve's policies did not apply so that Reserve's policies provided primary, rather than excess, coverage. *Cigna Lloyds Ins. Co. v. Kamins*, 924 S.W.2d 206, 210 (Tex. App.—Eastland 1996, no writ). For example, if there were a release of pollutants and the EPA sued Peak for violating CERCLA, the loss would not be covered by any of Peak's commercial policies. Peak would present its claim directly to Reserve, which would be the primary insurer under the policy language. Here, Peak submitted and Reserve paid a claim for Peak's loss of a major customer, a loss that Peak's commercial policies undisputedly did not cover. App.Vol.12.p.3552-59.

The tax court recognized that Peak's commercial insurance policies and Reserve's policies did not cover the same risks: "Reserve's policies covered only losses that were not covered by Peak's third-party policies." App.Vol.4.p.905. The tax court nonetheless erroneously construed the "other insurance" clause in Reserve's policies as requiring Peak to exhaust the limits of its commercial policies before Reserve's policies would pay any covered claim: "All the direct written policies included a provision that the coverage afforded by the policy would be valid only after insurance coverage from other insurers was exhausted. Peak had never come close to exhausting the policy limits of its third-party commercial insurance coverage." App.Vol.4.p.909. In this way, the tax court effectively converted Peak's commercial insurance policies into "other collectible policies" and Reserve's policies into excess policies without regard for whether the policies provided the same coverage. *Royal Indem. Co. v. Marshall*, 388 S.W.2d 176, 181 (Tex. 1965) ("Courts cannot make new contracts between the parties, but must enforce the contracts as written."). The tax court misconstrued and misapplied the "other insurance" clause as a matter of law. *See Hartford Cas. Ins. Co. v. Exec. Risk Specialty Ins. Co.,* No. 05-03-00546-CV, 2004 WL 2404382, at *2 (Tex. App.—Dallas Oct. 28, 2004, pet. denied) (mem. op.); *State Farm Fire & Cas. Co. v. Griffin*, 888 S.W.2d 150, 155 (Tex. App.—Houston [1st Dist.] 1994, no writ).

2. Relying on its Misreading of Reserve's Direct-Written Policies, the Tax Court Erroneously Determined that Reserve's Premiums Were Unreasonable and Not Negotiated at Arm's Length.

By misinterpreting and mischaracterizing Reserve's policies as excess insurance, the tax court inevitably found that (1) Reserve's premiums were unreasonable and not negotiated at arm's length, (2) there was no "real business purpose" for Reserve's policies, and (3) Peak lacked "a genuine need for acquiring additional insurance." App.Vol.4.p.909-11. The tax court viewed the economic realities as rendering the coverage illusory: "no unrelated party would reasonably agree to pay Reserve the premiums that Peak and the other insureds did for the coverage provided by the direct written policies." App.Vol.4.p.910. The tax court's misapprehension of Reserve's premiums flowed directly from its misreading of Reserve's policies, which constitutes an error of law this Court reviews de novo.

Here, Reserve's premiums were calculated using actuarial methods and objective criteria by Capstone and Mid-Continent, a large, well-respected insurance brokerage firm. App.Vol.2.p.480, Vol.5.p.1209-10, 1374, Vol.12.p.3560-61, Vol.13.p.3770-72. At trial, two actuaries provided uncontroverted testimony validating Reserve's premiums as reasonable.

App.Vol.13.p.3779-865, 3885-Vol.18.p.5329; *see also Securitas*, 108 T.C.M. (CCH) 490, at *10 (holding that premiums were "reviewed by outside actuaries and determined to be within the range of reasonable premiums"); *Crawford Fitting*, 606 F. Supp. at 139, 147 (holding that premiums charged based on recommendations from experienced actuaries were "proportionate to the risks they covered").

The tax court, despite recognizing that "Capstone calculated Reserve's premiums using objective criteria and what appear to be actuarial methods," nonetheless determined that "the absence of a real business purpose for Reserve's policies leads us to conclude that the premiums paid for the polic[i]es were not reasonable and not negotiated at arm's length." App.Vol.4.p.910. The tax court reached this conclusion only by mistaking Reserve's primary policies for excess policies in derogation of Texas law. Pointing to the absence of a significant history of losses for Peak, the tax court further suggested that this factor somehow undermined the reasonableness of Reserve's premiums. App.Vol.3.p.856, Vol.4.p.909.

The tax court's flawed reasoning however is akin to saying that automobile insurance is unnecessary for drivers who have not yet had an accident, or that fire insurance is unnecessary for homeowners who have never had their homes burned down. From an insurance standpoint, there is no risk unless there is uncertainty or fortuitousness; it may be uncertain whether the risk will materialize in any particular case. *Treganowan*, 183 F.2d at 290. Accordingly, a history of no losses is no guarantee that Peak will not suffer losses in the future. *See United Parcel Serv.*, 254 F.3d at 1018.

It is undisputed that Reserve's policies provided coverages for which loss data was not readily available to forecast potential losses. App.Vol.3.p.620, Vol.5.p.1256, 1294, Vol.12.p.3560-61. In the insurance industry, policies are regularly written without readily available loss data to forecast losses. App.Vol.5.p.1294, Vol.6.p.1501, 1574-75, Vol.20.p.5712. Furthermore, common insurance practices require no previous loss history for a captive to cover an insurable risk. App.Vol.4.1192-95, Vol.13.p.3763-64; *see also* Captive Insurance Companies Association ("CICA"), *Commercial Ins. & Captive Ins. Indus.: Commonly Accepted Practices* at 9-10 (Jan. 31, 2019), https://www.cicaworld.com/docs/default-source/default-document-library/cica_commonly_accepted_insurance_practices_risk_pools_jan2019.pdf?sfvrsn=0. A valid insurance policy only needs to cover risk of loss arising from a random, uncertain, or "fortuitous event." *Treganowan*, 183 F.2d at 290-91; *R.V.I. Guar.*, 145 T.C. at 232-33.

Here, Peak's owners explained why Reserve was formed and why Reserve's direct-written policies were needed. App.Vol.4.p.1117-25. Reserve was formed and issued direct-written policies to Peak because the commercial policies Peak had in place left several coverage gaps for risks Peak faced and such coverage was either too costly or otherwise unavailable in the commercial marketplace. App.Vol.7.p.2027-95; *see, e.g.*, *Crawford Fitting*, 606 F. Supp. at 147 (concluding brother-sister captive insurance arrangement that provided insurance for plaintiff that was unavailable or available only at higher rates had legitimate business purpose).

The tax court criticized Peak for maintaining its full set of third-party commercial coverage even after paying for additional coverage from Reserve. App.Vol.4.p.907. This criticism presumes that Reserve's insureds should have discontinued all third-party commercial coverage after purchasing coverage from Reserve. The tax court's criticism is misplaced because Peak's commercial insurance policies and Reserve's policies did not cover the same risks. App.Vol.7.p.2031-32, 2047-50, Vol.12.p.3570-88. Industry practice, especially for captive insurance, often sees companies that transition to captive insurance keep their commercial insurance coverage in place. App.Vol.4.1194-95; *see also* CICA, *supra*, at 8-9. The captive insurance in turn functions as a "risk financing vehicle" for previously self-insured risks. CICA, *supra*, at 8. Captive insurers fill in coverage gaps and write specialized insurance the market avoids or overprices. *Ocean Drilling*, 988 F.2d at 1138; *Crawford Fitting*, 606 F. Supp. at 147; *Rent-A-Ctr.*, 142 T.C. at 3-4; *Securitas*, 108 T.C.M. (CCH) 490, at *3.

The tax court's erroneous determination that the premiums for Reserve's direct-written policies were unreasonable and not negotiated at arm's length was based on its incorrect reading of Reserve's direct-written policies as providing only excess coverage. As such, this determination should be reversed.

3. Relying on Unfounded Assumptions, the Tax Court Erroneously Determined that Reserve Was Not Operated Like an Insurance Company Because It Was Managed by Hired Professionals.

To support its determination that Reserve not operated like an insurance company, the tax court considered it important that Capstone managed Reserve's planning, incorporation, and operations during the tax years in issue and that Reserve lacked employees of its own who performed those services. App.Vol.3.p.899-Vol.4.p.902. The tax court also criticized Zumbaum's inability to recite chapter and verse concerning Reserve's operations and the policies that it had issued. App.Vol.3.p.899-Vol.4.p.901. Although Reserve was incorporated in Anguilla, the tax court determined that "there is no evidence that any activities were ever performed there." *Id.* According to the tax court, Reserve performed little or no due diligence regarding its insurance and reinsurance policies. App.Vol.4.p.900-01. The tax court further faulted the documentation supporting the claim that Reserve paid during the tax years in issue. *Id.*

None of the foregoing, however, supports the tax court's determination that Reserve was not operated as an insurance company. Rather, they reveal the tax court's unfounded assumptions about the nature of the insurance business in general and captive insurance in particular.

First, the tax court overlooked existing caselaw recognizing that most captive insurance companies operate without any employees and routinely delegate operational functions, financial reporting, regulatory compliance and day-to-day tasks to captive managers. *See, e.g., United States v. Lequire*, 672 F.3d 724, 726 (9th Cir. 2012); *Kidde Indus., Inc. v. United States*, 40 Fed. Cl. 42, 51-53 (1997); *Rent-A-Center*, 142 T.C. at 24-25, 30; *Gulf Oil Corp. v.*

Comm'r, 89 T.C. 1010, 1013-14 (1987) (where Marsh & McLennan provided underwriting, rating, claims, reinsurance, record keeping, banking and checking services for a captive's operations), *aff'd*, 914 F.2d 396 (3d Cir. 1990); *Securitas*, 108 T.C.M. (CCH) 490, at *1, 10-11. Even the Commissioner concedes this point in his published rulings. *See* Rev. Rul. 2002-89, 2002-2 C.B. 984. Third-party "captive management firms" administer nearly all captives, including most captives of *Fortune 500* companies. CICA, *supra*, at 9.

Zumbaum's inability to recite details concerning Reserve's operations and the contents of its insurance policies provides no support for the tax court's conclusion that Reserve was not operated as an insurance company. Reserve retained professional management partly so that Peak's principals would not be burdened with the details of managing a small insurance company. Where, as here, Reserve was new to the insurance business, it is only reasonable that Reserve's principals would retain and rely on hired professionals. *See Kidde*, 40 Fed. Cl. at 53 ("As to KIC 'contracting out' most typical insurance functions, it would not seem unreasonable for KIC to do so when KIC first entered the insurance business. Through such contracts, a new entrant into the industry could eliminate uncertainty as to the cost of performing certain services and thereby secure greater predictability as to its operational costs.”). It is therefore meaningless that one of Reserve’s principals could not recall details about the very subjects that he had hired professionals to handle.

The tax court also seemed to be searching for activities that Reserve conducted in Anguilla. But neither the tax court nor the Commissioner identified any activities that Reserve should have but failed to perform in Anguilla, especially in view of Reserve’s having hired industry professionals to handle such activities to Capstone. Notably, the Commissioner’s position herein that Reserve’s transactions were not insurance in the commonly accepted sense was inconsistent with his position espoused in the 39 private letter rulings issued to 39 similarly situated captive insurance companies that were administered by Capstone. Indeed, the Commissioner had favorably ruled that such companies were insurance companies, specifically noting that the elements of risk distribution and commonly accepted notions of insurance were satisfied.[8]

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[8] *See supra* text accompanying note 2.

Capstone was instrumental in performing the due diligence regarding Reserve's policies and reinsurance policies. App.Vol.4.p.1079-80, 1090, 1125, Vol.5.p.1206-08. The tax court agreed that the feasibility study assessing whether a captive insurance company could be formed addressed many of the due diligence issues. App.Vol.3.p.898. Capstone, together with the assistance of Mid-Continent and independent actuaries, was also involved in setting the premiums under the policies that were issued by the captive insurance companies that Capstone administered and that participated in the PoolRe risk pool. App.Vol.5.p.1209-10, 1236--466. The tax court's opinion does not suggest what additional due diligence should have been conducted by or for Reserve.

The tax court's conclusion that Reserve was not operated as an insurance company was erroneous as a matter of law.

III. Alternatively, if the Tax Court Is Correct that Amounts Received as Premiums Were Not for Insurance, the Tax Court Erred in Holding that Such Amounts Constituted Taxable Income to Reserve, Instead of Nontaxable Capital Contributions.

As an insurance company, Reserve's income would be exempt from taxation because its gross receipts were less than $600,000. I.R.C. § 501(c)(15). The tax court held, however, that Reserve had not demonstrated that the amounts that Reserve received as premiums were not "fixed or determinable annual or periodical" income ("FDAP income") from sources within the United States that are subject to the 30% tax under I.R.C. § 881.

If this Court affirms the tax court's holding that Reserve was not an insurance company for tax purposes, this Court should reverse the tax court's determination that amounts received as insurance premiums constituted taxable income and render a decision that such amounts constituted nontaxable contributions to capital. This issue of whether the payments Reserve received qualify as taxable income under I.R.C. § 881(a) or nontaxable capital contributions under I.R.C. § 118(a) is subject to de novo review. *Twenty Mile Joint Venture, PND, Ltd., v. Comm'r*, 200 F.3d 1268, 1275 (10th Cir. 1999); *Scanlon White, Inc. v. Comm'r*, 472 F.3d 1173, 1175 (10th Cir. 2006).

Although the tax court determined that "Reserve was organized and regulated as an insurance company, and it satisfied the regulatory requirements of the domicile jurisdiction," the tax court also determined that Reserve "was not operated as a bona fide insurance company"; Reserve's premiums were unreasonable and not negotiated at arm's length because "*there was no legitimate business purpose for the policies that Reserve issued for the insureds*"; "*the only purpose PoolRe served through the quota share arrangement was to shift income from Peak to Reserve*"; and "*Reserve had not established that PoolRe was created or operated for legitimate nontax reasons*." App.Vol.3.p.894, Vol.4.p.911 (emphasis added).

Zumbaum and Weikel were the ultimate owners of Reserve and the Direct Insureds, which they owned directly or indirectly in equal shares. App.Vol.7.p.2047, Vol.18.p.5373. After concluding that there was no legitimate nontax reason for the policies Reserve issued and the payments Reserve received as premiums, the tax court determined that Reserve had not shown that the payments were otherwise nontaxable to Reserve. App.Vol.4.p.914.

The tax court's determination that there was no legitimate non-tax reason for Reserve's receipt of the payments is *dispositive* of the issue of the characterization of the amounts received from the perspective of Reserve. As discussed further below, the payments could not constitute payments in return for services provided by Reserve to the Direct Insureds, a loan of funds from them to Reserve or a deposit arrangement between the Direct Insureds and Reserve because these arrangements would have some legitimate non-tax purpose associated with such arrangements. The tax court's determination that there was no legitimate business purpose for such payments negates any such characterizations.

In evaluating whether the payments constituted nontaxable capital contributions to Reserve, the tax court noted that the issue turned on whether the parties to the insurance transactions treated or intended the payments to be contributions to capital. App.Vol.4.p.914. None of the cases the tax court cited, however, concluded the relevant analysis after determining the intent of the taxpayer involved. Indeed, in *Board of Trade v. Commissioner*, 106 T.C. 369 (1996), the tax court specifically found that none of the persons who contributed funds to the Board of Trade actually testified that the amounts at issue were intended to be contributions to capital, noting that "[d]irect proof of the motive of the payor is rarely available." *Id.* at 391. Instead, the analysis evaluated the facts and circumstances surrounding the financial transactions at issue to determine the transaction's proper character. Thus, the court in that case correctly considered the transaction's substance and economic realities.

Here, however, the tax court actually conducted no analysis and did not appear to consider the analysis that it conducted to evaluate whether the payments were insurance premiums. Had the tax court done so, the only conclusion that it could have reached was that the amounts constituted nontaxable contributions to capital to Reserve, not taxable income.

The testimony and other evidence Reserve presented established that the payments made under the policies at issue were insurance premiums. App.Vol.4.p.1237-38, Vol.13.p.3701-26. The tax court rejected this evidence, finding that there was no legitimate nontax reason for the payments to have been made to Reserve. Thus, the tax court determined that the payments made by the insureds were not supported by adequate consideration Reserve provided. Indeed, the tax court's broad determination that there was no legitimate nontax reason for the payments to have been made negates the provision of anything in return from Reserve, as this would be inconsistent with the tax court's conclusion that there was no legitimate nontax reason for the payments. The Commissioner agrees that "[w]here property is transferred from one affiliate" (i.e., the insureds here) "to a sister corporation without adequate consideration therefor, there is a constructive distribution to the common parent whether or not the motive for the transfer was an attempt improperly to allocate income or deductions between the corporations." Rev. Rul. 78-83, 1978-1 C.B. 9; *see Comm'r v. Greenspun*, 156 F.2d 917, 921 (5th Cir. 1946) (finding a constructive distribution from the sister corporation to the common shareholder and contribution to capital of the brother corporation); Rev. Rul. 69-630, 1969-2 C.B. 112. Because the funds in this situation are found in the sister corporation (i.e., Reserve), there is a deemed contribution of the funds from the common parent (i.e., Zumbaum and Weikel through Reserve's parent, Peak Casualty) to the sister corporation. *See* Boris I. Bittker & James S. Eustice, *Fed. Income Tax'n of Corps. & Shareholders* ¶¶ 8.06[10] (2020 ed.); Rev. Rul. 2005-40, 2005-2 C.B. 4.[9]

In *Carnation Co. v. Commissioner*, 71 T.C. 400 (1978), *aff'd*, 640 F.2d 1010 (9th Cir.), an unrelated company insured Carnation, which also formed a captive reinsurer in Bermuda. *Id.* at 1012. The original insurer reinsured 90% of its risk with the offshore captive, retaining 10% of the liability. *Id.*

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[9] In *Sammons v. Commissioner*, 472 F.2d 449 (5th Cir. 1972), the Fifth Circuit described this flow of funds as follows: "In the situation where funds are transferred from one such sibling corporation to another, the theory is that the funds pass from the transferor to the common stockholder as a dividend and then to the transferee as a capital contribution." *Id.* at 453.

Carnation paid all premiums to the original insurer, which insisted that Carnation further capitalize the reinsurer by almost $2.9 million on demand. *Id.* at 1012-13. By agreeing to this condition, the tax court held that Carnation retained the ceded risk, and there was no risk shifting and no insurance. *Id.*

The Commissioner "determined the 90% premium ceded to [the captive] was not deductible as a business expense" and claimed Carnation owed a deficiency. *Id.* at 1012. Unlike in this case, the Commissioner "characterized" Carnation's reinsurance premiums as its "capital contribution" to its captive subsidiary. *Id.* On summary judgment, the tax court concluded as a matter of law that no "insurance" existed, re-characterizing the reinsurance "premium" as a capital contribution Carnation made through the original insurer. *Id.* at 1013-14.

Each of the alternative arrangements (other than a contribution to capital) described in Revenue Ruling 2005-40 are inconsistent with the tax court's determination that there was no non-tax reason for Reserve to have received the payments at issue. Under these circumstances, the only potentially applicable characterization is a contribution to capital.

See James R. Browne, "*Reserve Mechanical* and *Syzygy*: *Income from Nothing*," 163 Tax Notes 1665 (June 10, 2019).

In the present case, the tax court's finding that there was no legitimate business purpose for the payment of the premiums by the Direct Insureds means that their transfers of funds to Reserve constitute constructive distributions by them to the ultimate common shareholders and contributions to capital to Reserve by said shareholders because, according to the tax court, there was no non-tax reason for the insureds to make such payments. App.Vol.4.p.913-14. Under these circumstances, Reserve had no taxable income.

Conclusion

This Court should reverse the tax court's decision that Reserve was not an insurance company for tax purposes. Alternatively, this Court should reverse the tax court's decision that the payments Reserve received as insurance premiums were taxable income to Reserve and render a decision that such amounts were nontaxable capital contributions to Reserve.

Respectfully submitted,

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Statement Regarding Oral Argument

Pursuant to 10th Circuit Local Rule 28.2(C)(3), Appellant requests oral argument. The issues presented for review in this appeal are significant with industry-wide implications for the captive insurance industry. These issues merit careful review and require examination of complex and esoteric tax and insurance law matters, taking into account the technical jargon and standards utilized therein, a voluminous trial record and decisions from other jurisdictions, including state courts. Given the complexity of these issues and the sheer size of the trial record, Appellant believes that oral argument will ensure that this Court has before it all of the underlying factual allegations and legal arguments that it needs for its review, and will significantly aid this Court's decisional process.

Certificate of Compliance

This brief contains complies with the type-volume limit of Federal Rule of Appellate Procedure 32(a)(7)(B) because, excluding the items exempted by Federal Rule of Appellate Procedure 32(f), this brief contains 12,952 words.

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/s/ Val J. Albright
Val J. Albright

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/s/ Val J. Albright
Val J. Albright

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Attachments

(Tax Court's June 18, 2018 Memorandum Findings of Fact and Opinion and Tax Court’s September 28, 2018 Decision)

Attachment A

Tax Court's

June 18, 2018 Memorandum Findings of Fact and Opinion

DRC

T.C. Memo. 2018-86

UNITED STATES TAX COURT

RESERVE MECHANICAL CORP., f.k.a. RESERVE CASUALTY CORP.,
Petitioner v.
COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket No. 14545-16. Filed June 18, 2018.

Val J. Albright and Michelle Y. Ku, for petitioner.

Thomas F. Harriman, Naseem Jehan Khan, Grubert Roger Markley, and Justin D. Scheid, for respondent.

MEMORANDUM FINDINGS OF FACT AND OPINION

KERRIGAN, Judge: Respondent determined the following deficiencies in petitioner's Federal income tax for tax years 2008-10 (tax years in issue):

SERVED Jun 18 2018

[*2]

Year	Deficiency
2008	$144,538
2009	164,418
2010	168,305

Unless otherwise indicated, all section references are to the Internal Revenue Code (Code) in effect for the tax years in issue, and all Rule references are to the Tax Court Rules of Practice and Procedure. All monetary amounts are rounded to the nearest dollar.

The issues for consideration are: (1) whether transactions that petitioner executed during the tax years in issue constituted insurance contracts for Federal income tax purposes, and therefore, whether petitioner was exempt from tax as an "insurance company" described in section 501(c)(15); (2) whether petitioner was eligible to make an election under section 953(d) to be treated as a domestic corporation; and (3) if petitioner was not an insurance company and was not eligible to make an election under section 953(d), whether payments that it received for the tax years in issue are subject to the 30% tax imposed by section 881(a).

[*3] FINDINGS OF FACT

Some of the facts have been stipulated, and the stipulation of facts and the attached exhibits are incorporated herein by this reference. When petitioner filed its petition, it was a corporation organized under the laws of Anguilla, British West Indies. In our findings of fact we use the terms “insurance”, “risk”, “coverage”, and similar terms to describe the form of the transactions, but our use of those terms does not reflect any ruling as a matter of fact or law with respect to insurance or insurance companies within the meaning of subchapter L of the Code.

I. Overview of Reserve Mechanical Corp.

Reserve Mechanical Corp. f.k.a. Reserve Casualty Corp. (hereinafter, Reserve) was incorporated in Anguilla in 2008 under the provisions of section 9 of the Companies Act. Anguilla is an overseas territory of the United Kingdom. During the tax years in issue Reserve held a Class B General Insurance License (Class B insurance license) issued by the Financial Services Commission of Anguilla. The Financial Services Commission is the Anguillan governmental entity authorized to license, regulate, and oversee the financial services industry in Anguilla, including insurance companies.

During the tax years in issue Peak Casualty Holdings, LLC (Peak Casualty), a Nevada limited liability company, owned 100% of Reserve’s stock. Norman L.

[*4] Zumbaum and Cory Weikel each owned 50% of Peak Casualty. Zumbaum and Weikel were U.S. citizens who resided in Idaho during the tax years in issue.

Zumbaum and Weikel served as directors for Reserve. Zumbaum was its chief executive officer, president, treasurer, and assistant secretary. Weikel was its vice president, secretary, and assistant treasurer.

A. Peak's Operations

Peak Mechanical & Components, Inc. (Peak), was incorporated in 1997, and its principal place of business was in Osburn, Idaho. Zumbaum and Weikel each owned 50% of Peak's outstanding stock, and Peak elected to be treated as an S corporation for Federal income tax purposes. Peak engaged in the business of distributing, servicing, repairing, and manufacturing equipment used for underground mining and construction. By 2008 Peak had grown significantly. In 2008 and 2009 it had 17 employees, including management personnel, shop managers and staff, and outside salespersons. In 2010 it had 13 employees.

Peak's facilities were in Idaho's Silver Valley, an active mining district, and were within the Bunker Hill Mining & Metallurgical Complex, a "Superfund Site" designated by the U.S. Environmental Protection Agency (EPA) (Bunker Hill Superfund Site). See Bunker Hill Mining & Metallurgical Complex, Smelterville, ID, https://cumulis.epa.gov/supercpad/SiteProfiles/index.cfm?fuseaction=

[*5] second.Cleanup&id=1000195#bkground (last visited June 13, 2018). The Bunker Hill Superfund Site was polluted with heavy metals, including zinc and lead, as a result of historic mining practices. The site was subject to EPA oversight and regulation. As part of its business Peak cleaned equipment used in polluted mines, and it took measures to protect its employees and to control fluid runoff containing pollutants and other hazardous materials.

During the tax years in issue Peak's equipment was used in approximately 12 mines in Idaho, Nevada, and Washington, and it sold some products outside the United States. It manufactured and serviced a line of submersible pumps used to remove groundwater from working areas, and it supplied and serviced large ventilation fans and air barrier doors, which are used to improve air quality and control air flow in underground mines. It rebuilt and customized trucks to be used as support vehicles in mining operations, and it manufactured and repaired guide wheels for hoist conveyances, which are used in mine shaft elevators.

B. Peak's Commercial Insurance Coverage

During all of the tax years in issue Peak maintained insurance coverage with third-party commercial insurers. It held policies with third-party insurers that covered general liability, worker's compensation, commercial property, inland

[*6] marine, and international risk. It maintained the following policies with the following insurance companies:

Insurance provider	Policy type & limit categories	Policy limits
Employers Mutual Casualty Co. (EMC)	General liability	
	Each occurrence	$1,000,000
	Damage to rent premises	100,000
	Medical expense	5,000
	Personal & advertising injury	1,000,000
	General aggregate limit	2,000,000
	Products/completed operations aggregate limit	2,000,000
EMC	Commercial property	
	Blanket policy limit	914,940
EMC	Commercial inland marine (covering electronic data processing equipment)	
	Limit for hardware	8,000
Idaho State Insurance Fund	Worker's compensation employer's liability	
	Each accident	100,000
	Disease, each employee	100,000
	Disease, policy limit	500,000
Ace American Insurance Co.	International risk policy	
	Foreign general liability, automobile liability, employers liability	1,000,000
	Foreign accidental death & dismemberment	5,000
	Kidnap & extortion	50,000

Peak also maintained auto insurance policies with State Farm for several vehicles that its employees drove.

[*7] For tax year 2006 Peak claimed a deduction on its Form 1120S, U.S. Income Tax Return for an S Corporation, for insurance expenses of $38,810. For tax year 2007 it claimed a deduction for insurance expenses of $95,828. Peak's income statement reflects that for the first six months of 2008 it incurred insurance expenses of $57,300.

C. Peak's History of Losses and Insurance Claims and Potential Losses

Sometime before the tax years in issue Peak engaged a large accounting firm to review returns it had filed for previous years. Peak was advised that its income had been underreported and that it needed to restate its income for three tax years. It contacted the Internal Revenue Service (IRS) about restating its income, and it paid additional tax as a result. The IRS waived penalties.

In years prior to the tax years in issue Peak had filed insurance claims under its auto insurance policies for losses associated with company vehicles. In February 2008 a snowstorm damaged the roof of one of Peak's buildings, and it filed a claim with EMC. EMC conducted an examination and concluded that the repair would cost $2,000. Peak had a separate examination of the roof which concluded that $2,000 would be insufficient to repair the roof. It tried to negotiate with EMC for a larger payout, but after negotiations EMC agreed to pay only $2,000. Peak paid $25,000 out of pocket to have the roof replaced.

[*8] D. RocQuest and ZW Enterprises

During the tax years in issue Zumbaum and Weikel equally co-owned 100% of the membership interests in two other entities: RocQuest, LLC (RocQuest), and ZW Enterprises, LLC (ZW). RocQuest and ZW were Idaho limited liability companies that were treated as partnerships for Federal income tax purposes. RocQuest owned real estate in Osburn and Hayden Lake, Idaho, and Elko, Nevada. It leased the properties in Osburn and Elko to Peak for Peak's business operations. It leased the property in Hayden Lake to Premier Electric Motor, Inc. (Premier), an entity that Zumbaum and Weikel partially owned. Premier conducted repair work on electrical motors and received most of its business from Peak.

ZW was an entity that Zumbaum and Weikel organized to facilitate a loan to an ex-employee. After leaving Peak the ex-employee wanted to purchase a bar in Osburn, and Zumbaum and Weikel, through ZW, helped finance the purchase. ZW held a 10% ownership interest in the bar. Zumbaum and Weikel organized ZW so that Peak would not have any liability vis-a-vis the bar.

II. Formation of Reserve

Before forming Peak Zumbaum and Weikel worked for Mining Equipment, Ltd. (MEL), based in Colorado. Robert Pope was the president and owner of

[*9] MEL. Zumbaum and Weikel viewed Pope as a mentor. Pope recommended that Peak should obtain more insurance, and he suggested forming a captive insurance company. He advised Zumbaum and Weikel to contact Capstone Associated Services, Ltd. (Capstone).

A. Overview of Capstone

In 1998 Stewart Feldman formed Capstone, a Texas limited partnership with an office in Houston, Texas.[1] Capstone offered insurance-related services, including captive feasibility studies, assistance with regulatory filings, accounting, and other services related to forming a captive insurance company. It offered a "turnkey" administrative program to help small and intermediate size captives overcome transaction costs.

Capstone employed insurance and accounting professionals, and it was closely affiliated with the Feldman Law Firm, LLP (Feldman firm), which provided legal services to Capstone clients. Feldman was the Feldman firm's managing partner and chief executive officer of Capstone's corporate general partner.

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[1]Feldman testified that Capstone was a Texas limited partnership. Exhibit 9-J includes a reference to "Capstone Associated Services, Ltd., a Florida limited partnership".

[*10] Capstone would perform a feasability study for a client, which provided an opinion as to the advisability of establishing a captive insurance company. Generally, a feasibility study identified factors that would make a captive insurance arrangement desirable for a particular client, including a discussion of the client's business operations and risks, insurance coverage that the client held through third-party insurers, and potential coverage gaps ("exposures") that might be relevant to the client's business. For clients that proceeded with the formation of a captive insurance company, Capstone performed a comprehensive set of captive management and administrative services.

Capstone provided the services of its insurance professionals, and it assisted clients in selecting and administering policies that the captive entities issued. It advised clients in selecting policies, drafted policies, and provided services to handle claims adjustment and settlement. Capstone advised clients as to the premiums that should be charged for policies. It charged Reserve approximately $15,000 a quarter for services, including disbursements on Reserve's behalf.

B. Onsite Visit of Peak's Operations

Zumbaum and Weikel contacted Capstone to discuss forming a captive insurance company. Peak provided documents relating to its business operations, which Capstone compiled as "Client Background Documents" for a feasibility

[*11] study. Peak provided financial and income statements, tax returns, and documentation of insurance policies that it held with third-party insurers. A copy of Rocquest's partnership tax return for 2007 was included with the background documents.

On August 13, 2008, Feldman and Lance McNeel, director of Capstone's insurance department, visited Peak's facilities. Feldman and McNeel met with Zumbaum and Weikel, and they toured locations where Peak conducted operations in Osburn and the facility in Hayden Lake. McNeel took pictures of Peak's operations and inventory. Feldman and McNeel discussed with Zumbaum and Weikel documents that Peak had provided and discussed products that Peak sold and its repair and manufacturing operations. They discussed possible gaps in Peak's existing insurance coverage. The onsite visit of Peak's facilities lasted six to eight hours.

C. Feasibility Study for Peak

In August 2009 the finalized feasibility study for Peak was issued, about nine months after the start of Reserve's operations. The background documents compiled to support the feasibility study included documents that reflected Peak's financial information through August 31, 2009, and the background file was updated as late as December 14, 2009. Capstone's feasibility study for Peak

[*12] concluded that "as of the date of this report, the viability of a small captive insurer * * * to address the insurance and risk management issues discussed herein is feasible, reasonable, and practical, and is the best alternative risk mechanism option for the proposed insured ".

The feasibility study included an explanation of tax benefits for small and intermediate-size captives under sections 831(b) and 501(c)(15). It included a summary of Peak's business operations, a table reflecting Peak's commercial insurance policies, and a list of "other risk management issues". The study did not provide detailed information regarding the other risks that conventional insurance might not cover. The study provided brief descriptions of these risks, but it included no information on the probability that these risks might occur. The study did not include information about Rocquest and ZW. The study identified specific policies that Peak could consider handling through a captive insurer. It identified potential domiciles for Peak's small captive and concluded: "Anguilla is the preferred choice."

Capstone and Willis HRH of Houston (Willis), an insurance broker and risk management consulting firm that collaborated regularly with Capstone during the tax years in issue, jointly issued the feasibility study. Robert Snyder signed the study as senior vice president of Willis. McNeel was principal author of the study,

[*13] and Snyder's role was to review it. Snyder did not perform any independent investigation of Peak's business operations, and he based his review on the background documents that Capstone compiled and an oral briefing from McNeel.

D. License Application & Organization

On October 10, 2008, Feldman wrote a letter to the Financial Services Commission of Anguilla notifying the commission that Capstone would be providing its "usual comprehensive set of captive administrative services" to Reserve. On October 21, 2008, Zumbaum, Weikel, and Feldman endorsed and submitted Reserve's Application For a Class B Insurer's License in Anguilla. The application contained a business plan for Reserve. The business plan stated that in its early years Reserve "is expected to be operated under section 501(c)(15) of the U.S. Federal Tax Code which limits gross receipts to $600,000".

On December 3, 2008, Reserve was incorporated in Anguilla, and on the same date the Financial Services Commission granted it a Class B insurance license valid through December 31, 2008. Reserve's insurance license application identified Capstone and Atlas Insurance Management (Anguilla) Limited (Atlas) as key service providers. On December 10, 2008, Reserve received an initial capitalization of $100,000, the minimum amount required for a Class B insurer under Anguillan law.

[*14] Capstone engaged Atlas to serve as the authorized representative and resident insurance manager for Capstone clients in Anguilla. Atlas transmitted documents that Capstone prepared for Reserve's license application to the Anguillan regulatory authorities. After Atlas submitted the license application, its principal role was to provide a local business address for Reserve.

III. Reserve's Direct Written Policies

During the tax years in issue Reserve issued direct written insurance policies, with Peak, Rocquest, and ZW as the named insureds on each policy. All of the policies that Reserve issued the insureds showed one premium price and did not specify amounts to be paid by each insured. All of the policies contained the following provision:

> THE COVERAGES AFFORDED BY THIS POLICY ARE EXCESS OVER ANY OTHER VALID AND COLLECTIBLE INSURANCE POLICY ISSUED BY ANY OTHER INSURER * * *. THE LIMITS AND DEDUCTIBLES STATED HEREIN ONLY APPLY AFTER COVERAGE IS EXHAUSTED FROM ANY AND ALL OTHER VALID INSURANCE POLICIES ISSUED BY ANY OTHER INSURER.

During the tax years in issue Peak maintained its insurance coverage with third-party insurers.

For the tax years in issue Capstone selected and drafted the policies that Reserve issued for Peak and the other insureds. Zumbaum scanned the policies

[*15] but did not review them in detail, and he was unaware of specific terms in the policies. Capstone employees, including McNeel, determined the premiums that Reserve charged for the policies. For each of the tax years in issue McNeel prepared a rating worksheet that calculated the premiums for Reserve's direct written policies. Zumbaum and Weikel had ultimate authority to determine the premiums, and they always approved the amounts that Capstone advised.

McNeel calculated the premiums using ratings bases specific to Peak's business; for most policies the ratings base was Peak's annual projected sales. He applied to the ratings base for each policy a base rate that varied according to the type of insurance being provided, which yielded a base premium price for the first $250,000 of coverage. Capstone maintained a spreadsheet of base rates for "common policies" that it administered on behalf of its clients' captive insurance companies (Capstone entities). McNeel prepared the spreadsheet by reviewing the premiums that all Capstone entities had charged in previous years, and the spreadsheet provided both an average and a range of rates from which he could choose for each type of policy. On Reserve's rating worksheets McNeel adjusted the base premium amounts using increased limit factors, which accounted for the increased coverage limits in its policies.

[*16] Capstone engaged persons employed by an outside firm, Mid-Continent General Agency, Inc. (Mid-Continent), to develop premium quotations. A Mid-Continent employee generated pricing indications using information that Capstone compiled about its clients. McNeel relied on the Mid-Continent indications in setting the premiums that Reserve and other Capstone entities charged for their direct written policies.

In 2009 Mid-Continent wrote Capstone a letter which stated that "many of the insurance coverages written by the [Capstone] captives are nonstandard lines of insurance for which there is no 'manual rating'". The letter stated further that "[u]nderwriting judgment, while 'subjective,' is a key component of evaluating and pricing risk" in the methodology that Mid-Continent employees used to generate pricing indications. Peak and the other insureds under Reserve's policies had insufficient histories of insurance claims and losses to use as bases for determining premiums, and McNeel did not rely on loss data in calculating the premiums for Reserve's direct written policies.

A. <u>2008 Direct Written Policies</u>

For 2008 Reserve issued 13 direct written insurance policies, with Peak, RocQuest, and ZW as the named insureds. Each policy listed PoolRe Insurance Corp. (PoolRe) as the stop loss insurer. These policies were effective from

[*17] December 4, 2008, through January 1, 2009. The aggregate amount of insurance was $13 million, and the premiums were $412,089. Reserve issued the following direct written policies for 2008:

Name of policy	Combined premium[1]	Aggregate policy limit
Excess Directors & Officers Liability	$17,122	$1,000,000
Special Risk--Loss of Major Customer	7,268	1,000,000
Special Risk--Expense Reimbursement	31,312	1,000,000
Special Risk--Loss of Services	4,874	1,000,000
Special Risk--Weather Related Business Interruption	7,268	1,000,000
Excess Pollution Liability	82,850	1,000,000
Special Risk--Tax Liability	65,408	1,000,000
Excess Intellectual Property Package	18,169	1,000,000
Special Risk--Regulatory Changes	64,899	1,000,000
Special Risk--Punitive Wrap Liability	55,233	1,000,000
Excess Employment Practices Liability	24,256	1,000,000
Excess Cyber Risk	28,343	1,000,000
Special Risk--Product Recall	5,087	1,000,000
Total	412,089	13,000,000

[1]As noted, each of the direct written policies that Reserve issued showed only one premium price for coverage to be provided to all three named insureds. According to additional agreements executed by the parties, which are described in more detail below, a portion of the premiums due for the direct written policies were to be paid to a stop loss insurer. It is unclear from the record which of the insureds paid premiums under the direct written policies, in what amounts they paid, and to whom. Accordingly, the table reflects only the combined premium price shown on each of the policies.

[*18] Seven of the 2008 policies had retroactive dates or look-back provisions. The policies for excess directors and officers liability, excess pollution liability, excess intellectual property, punitive wrap liability, excess employment practices liability, and excess cyber risk provided that the policies would cover claims occurring after January 1, 2005. The tax liability policy provided that it would cover all tax periods for tax returns whose due dates (without extensions) were during the 2008 calendar year. The remaining six policies for loss of major customer, expense reimbursement, loss of services, weather-related business interruption, intellectual property package, regulatory changes, and product recall had no retroactive dates.

B. <u>2009 Direct Written Policies</u>

For 2009 Reserve issued 11 direct written insurance policies. Peak, RocQuest, and ZW were the named insureds, and the policies were effective for January 1, 2009, through January 1, 2010. Each policy listed PoolRe as the stop loss insurer. The total premiums were $448,127. The direct written policies for 2009 did not include insurance for weather-related business interruption and excess cyber risk as included in the 2008 direct written policies. Reserve issued the following policies for 2009:

[*19]

Name of policy	Combined premium	Aggregate policy limit
Excess Directors & Officers Liability	$17,075	$1,000,000
Special Risk--Loss of Major Customer	50,625	500,000
Special Risk--Expense Reimbursement	26,686	1,000,000
Special Risk--Loss of Services	62,791	1,000,000
Excess Pollution Liability	60,750	500,000
Special Risk--Tax Liability	45,562	500,000
Excess Intellectual Property Package	34,425	1,000,000
Special Risk--Regulatory Changes	47,588	500,000
Special Risk--Punitive Wrap Liability	40,500	500,000
Legal Expense Reimbursement	26,687	1,000,000
Special risk--Product Recall	35,438	500,000
Total	448,127	8,000,000

On January 1, 2009, an Atlas employee executed the 2009 policies on Reserve's behalf. During 2009 Capstone formed its own licensed insurance management company in Anguilla, and Capstone replaced Atlas with its own employee to serve as Reserve's resident insurance manager and authorized representative.

C. 2010 Direct Written Policies

For 2010 Reserve issued 11 direct written policies. Peak, RocQuest, and ZW were the named insureds. Each policy listed PoolRe as the stop loss insurer. On January 1, 2010, a Capstone employee executed the policies as Reserve's

[*20] authorized representative. The effective policy period for the 2010 policies was January 1, 2010, through January 1, 2011, and the total premiums were $445,314. Reserve issued the following policies for 2010:

Name of policy	Combined premium	Aggregate policy limit
Excess Directors & Officers Liability	$17,075	$1,000,000
Special Risk--Loss of Major Customer	47,812	500,000
Special Risk--Expense Reimbursement	23,024	1,000,000
Special Risk--Loss of Services	62,791	1,000,000
Excess Pollution Liability	60,750	500,000
Special Risk--Tax Liability	45,562	500,000
Excess Intellectual Property Package	34,425	1,000,000
Special Risk--Regulatory Changes	47,588	500,000
Special Risk--Punitive Wrap Liability	40,500	500,000
Legal Expense Reimbursement	30,349	1,000,000
Special Risk--Product Recall	35,438	500,000
Total	445,314	8,000,000

D. Claims Under Direct Written Policies

The only claim made under one of Reserve's direct written policies was made in 2009. Peak made a claim under the policy for loss of a major customer. The date of occurrence for the claim was January 5, 2009, according to a notice of claim filed on April 6, 2009. The claim notice reported a reduction of orders from

[*21] Stillwater Mining Co. that reportedly resulted in a 16% reduction in Peak's sales for that period. The claim as reflected on the claim notice was for $164,820.

On April 21, 2009, Reserve issued Peak a check for $150,000. The check was drawn on Reserve's bank account at AmericanWest Bank in Wallace, Idaho. Jill Howard (Howard), a Peak employee, signed the check. On May 27, 2009, Reserve and Peak executed a settlement and release agreement in which Reserve agreed to pay the calculated value of $164,820 for Peak's loss of customer claim. On that date Reserve issued a second check, which Howard signed, from its AmericanWest bank account to Peak for $14,820. The claim notice indicates that on June 29, 2009, Reserve closed the claim for the Stillwater loss.

The claim notice states that Reserve reopened the claim for the Stillwater loss on account of extended losses on August 25, 2009. On September 10, 2009, a third check that Howard signed for $175,000 was issued from the AmericanWest bank account to Peak. After the tax years in issue, on January 30, 2012, Reserve and Peak executed an addendum to the settlement and release agreement, which stated that the amount to be paid in connection with the Stillwater loss was $339,820 and that the amount had been paid already. Reserve paid all amounts to Peak for the Stillwater loss out of its own funds.

[*22] IV. PoolRe, the Quota Share Arrangement, and the CreditRe Reinsurance Arrangement

A. PoolRe's Stop Loss Endorsements

In 2008 PoolRe was domiciled in the British Virgin Islands. Stephen Friedman was the owner of PoolRe. In 2009 PoolRe redomiciled in Anguilla, and starting on April 15, 2009, and through 2010 it held a Class B insurance license in Anguilla. PoolRe had no employees in Anguilla or in the United States. Capstone administered PoolRe's operations and maintained the books and records for PoolRe. Zumbaum was unaware of what Reserve did in Anguilla during the tax years in issue.

For each of the tax years in issue Reserve and PoolRe executed a Joint Underwriting Stop Loss Endorsement (stop loss endorsement), which by its terms applied to all of the direct written policies that Reserve issued. Pursuant to the stop loss endorsements, PoolRe agreed to serve as a joint underwriter and stop loss insurer for the direct written policies. Reserve was the lead insurer with respect to the policies, and PoolRe assumed an amount of excess risk.

According to the terms of the stop loss endorsement for each of the tax years in issue, PoolRe would receive a percentage of the total combined premiums due from the insureds under Reserve's direct written policies. Pursuant to the

[*23] 2008 and 2009 stop loss endorsements, 81.5% of the premiums charged for the direct written policies was to be paid to Reserve as lead insurer, and the remaining 18.5% was to be paid to PoolRe as stop loss insurer. The terms of the 2010 stop loss endorsement were modified and provided that Reserve would receive 80.1% of the combined premiums under the direct written polices and PoolRe would receive 19.9%.

Under the terms of the stop loss endorsements for all tax years in issue, PoolRe's obligation to pay on claims made against Reserve's direct written policies arose only if a total claims threshold was exceeded, and according to the endorsements PoolRe was obligated to cover a certain amount of payments in excess of that threshold. The 2008 and 2009 stop loss endorsements provided that PoolRe would have no liability until claims reported under the direct written policies exceeded 100% of the total combined premiums due under the policies and one of four attachment points occurred.

Under the 2008 and 2009 stop loss endorsements attachment points were triggered when a certain number of losses reached a set amount. For example, the first attachment point described in the stop loss endorsements was reached when the lead insurer received two original loss claims for events of $100,000 or more, and the fourth attachment point was reached when the lead insurer received five

[*24] claims of $20,000 or more for separate events. PoolRe's participation level under the 2008 and 2009 stop loss endorsements, i.e., the total amount it might have to pay, was expressly limited to the lesser of: (1) the amount of the claim that exceeded the appropriate attachment point, (2) 150% of the combined direct written premiums, or (3) the named insureds' pro rata share of the total current year loss funding pool up to a maximum of 125% of the stop loss insurer's combined premium revenue from all current year stop loss coverage.

Under the modified 2010 stop loss endorsement PoolRe's liability to pay on claims made against Reserve's direct written policies arose when all reported claims exceeded 35% of total combined premiums. For reported claims above the 35% threshold the 2010 stop loss endorsement provided that PoolRe was liable to pay 50%, and PoolRe's participation level was limited to 100% of total combined premiums.

PoolRe entered into stop loss endorsements for insurance policies that other Capstone entities issued. During the tax years in issue PoolRe entered into endorsements for around 400 policies that between 51 and 56 Capstone clients issued and that covered in the aggregate around 150 insureds. The terms of the stop loss endorsements that PoolRe executed with Reserve and with the other Capstone entities were similar.

[*25] B. Quota Share Policies

PoolRe pooled the premiums that it was entitled to receive under the stop loss endorsements, and it executed reinsurance agreements designed to redistribute them to the Capstone entities. For each of the tax years in issue Reserve and the other Capstone entities each executed with PoolRe a Quota Share Reinsurance Policy (quota share policy). Pursuant to their respective quota share policies Reserve and each of the other Capstone entities agreed to assume coverage for a specified portion (quota share) of the risks that PoolRe had assumed according to the terms of the stop loss endorsements (stop loss pool).

The quota share that Reserve assumed under the quota share policy for each tax year in issue was calculated so that Reserve was entitled to receive payments from PoolRe equal to the premiums that PoolRe was entitled to receive from Peak and the other insureds pursuant to the stop loss endorsement. Pursuant to the stop loss endorsement for 2008 PoolRe was to receive premiums of $76,236, representing 18.5% of the total combined premiums that Peak and the other insureds were charged under the direct written policies. Under the 2008 quota share policy PoolRe agreed to pay Reserve reinsurance premiums of $76,236 for assuming approximately 1.35% of PoolRe's stop loss pool. Reserve's general ledger reflects that Reserve bore no losses under the quota share policy for 2008.

[*26] It reflects that Reserve received payments from PoolRe for the 2008 quota share policy that totaled $76,236, which were designated in the ledger as reinsurance premiums.

For 2009 and 2010 Reserve recorded no losses in connection with the quota share policies. Reserve's general ledger reflects that it received payments pursuant to the 2009 quota share policy of $82,903, which equaled the percentage of premiums that PoolRe was entitled to receive for the 2009 stop loss endorsement (i.e., 18.5% of $448,127) from Peak and the other insureds. PoolRe was due to receive premiums of $88,617 under the 2010 stop loss endorsement (i.e., 19.9% of $445,314) from Peak and the other insureds, and pursuant to the 2010 quota share policy PoolRe agreed to pay Reserve $88,617 for assuming about 1.44% of the stop loss pool.

C. CreditRe Reinsurance Arrangement

For the tax years in issue Reserve executed with PoolRe a Credit Insurance Coinsurance Contract (coinsurance contract), under which Reserve agreed to assume a small portion of risk that PoolRe had agreed to assume from an unrelated company, CreditRe Reassurance Corp., Ltd. (CreditRe). Gary Fagg owned CreditRe, which had no employees. CreditRe had no knowledge of Reserve's formation or operations.

[*27] The coinsurance contracts recited that, pursuant to a preexisting reinsurance treaty, CreditRe ceded to PoolRe for the tax years in issue a pro rata share of the liability and premiums associated with a large pool of vehicle service contracts. According to statements in the coinsurance contracts, the vehicle service contracts in the pool originated from Lyndon Property Insurance Co. (Lyndon), a large U.S.-based direct writer of insurance. An exhibit prepared in connection with Reserve's Form 1024, Application for Recognition of Exemption Under Section 501(a), represents that Lyndon ceded the alleged vehicle contracts to ARIA (SAC), Ltd. (ARIA), a Bermuda-domiciled insurance company.

According to Fagg ARIA then ceded a portion of the liability for the vehicle service contracts to CreditRe, which ceded a small portion to PoolRe. The coinsurance contracts provided that PoolRe would cede shares of its portion of the liability for the vehicle service contracts to Reserve. The terms of the coinsurance contracts required Reserve to reinsure 0.9946%, 1.1576%, and 0.9100% of the annualized liability of PoolRe for the tax years in issue, respectively. PoolRe executed similar coinsurance contracts involving the vehicle services contracts with other Capstone entities during the tax years in issue.

[*28] V. Reserve's Tax Returns

On its tax returns filed for the tax years in issue Reserve reported that it used the accrual method of accounting. For each of the tax years in issue Reserve elected to be treated as a domestic insurance company pursuant to section 953(d). For tax year 2008 it filed Form 990-EZ, Short Form Return of Organization Exempt From Income Tax, and for tax years 2009 and 2010 it filed Forms 990, Return of Organization Exempt From Income Tax.

On the Form 990-EZ for 2008 Reserve reported program service revenue of $481,589 and total expenses of $179,811. It reported a small amount of revenue attributable to investment income. All expenses reported for 2008 were "other expenses" and were detailed on an attached schedule. The attached schedule identified expenses for management and legal fees, office expenses, depreciation, travel, reinsurance commissions, and loss expenses.

On its 2009 Form 990 Reserve reported program service revenue of $524,627. It also reported revenue from investment income and "other revenue". For 2009 it reported total expenses of $517,514. Part IX, Statement of Functional Expenses, of the 2009 Form 990 listed expenses for management and legal fees, office expenses, depreciation, conferences, conventions, and meetings, reinsurance commissions, loss expenses, licenses and Government fees, and "other expenses".

[*29] On its 2010 Form 990 Reserve reported program service revenue of $511,314, and reported investment income and "other revenue". For 2010 it reported total expenses of $164,768. Part IX of the 2010 Form 990 listed expenses for management and legal fees, office expenses, depreciation, conferences, conventions, and meetings, reinsurance commissions, loss expenses, licenses and government fees, and "other expenses".

On August 31, 2009, Zumbaum submitted on behalf of Reserve a Form 1024, requesting recognition as a tax-exempt organization. At a later date Reserve withdrew its application.

VI. Reserve's Financial Statements

For tax years 2009 and 2010 statutory financial statements required by and in compliance with Anguillan law were filed with the Financial Services Commission on Reserve's behalf.[2] Liptz & Associates (Liptz) prepared and filed these financial statements. David Liptz, a licensed certified public accountant, was head of Liptz, and he and his firm performed audits of Reserve for the tax years in issue. During the tax years in issue Reserve met the minimum solvency margin requirements under Anguillan law.

[2]The Anguilla Financial Services Commission waived the requirement to file an audited financial statement for 2008 because Reserve was not incorporated until the fourth quarter of that year.

[*30] VII. Notice of Deficiency

On March 29, 2016, respondent issued Reserve a notice of deficiency for the tax years in issue (notice). In the notice respondent determined that Reserve was not a tax-exempt insurance company within the meaning of section 501(c)(15). Respondent determined that Reserve's insurance and reinsurance transactions lacked economic substance and in the alternative that it was not an insurance company within the meaning of subchapter L of the Code because its predominant activity was not insurance.

Respondent determined that Reserve was not eligible to make an election under section 953(d) to be treated as a domestic corporation and that Reserve was required to file Forms 1120-F, U.S. Income Tax Return of a Foreign Corporation, for the tax years in issue. The notice stated that substitutes for returns had been prepared for Reserve for the tax years in issue. The notice determined that the amounts that Reserve reported as program service revenue for the tax years in issue constituted taxable income.

The proposed tax liabilities in the notice were based on respondent's determination that the 30% withholding tax imposed by section 881(a) applied to income that Reserve received for the tax years in issue. Respondent determined that because Reserve had failed to file Forms 1120-F for the tax years in issue

[*31] within 18 months of their respective due dates (as provided in section 6072) it was barred from claiming all deductions and credits in computing its taxable income.

OPINION

Generally, the taxpayer bears the burden of proving that the Commissioner's determinations set forth in the notice of deficiency are incorrect. Rule 142(a); Welch v. Helvering, 290 U.S. 111, 115 (1933). Under section 7491(a) in certain circumstances the burden of proof may shift from the taxpayer to the Commissioner. Reserve does not contend that the burden of proof shifts to respondent under section 7491(a) as to an issue of fact.

Both parties presented experts to support their respective positions. We focus on the degree to which experts' opinions are supported by the evidence. We do not use titles because we do not wish to imply a greater deference to academic experts than to industry experts. We do not discuss the opinion of any expert which does not pertain to our factual conclusions.

I. Applicable Statutes

Section 501(a) and (c)(15) provides for the tax-exempt treatment of income received by insurance companies that meet certain criteria. An insurance company as defined in section 816(a) (other than a life insurance company) shall be exempt

[*32] from tax if (1) its gross receipts for the taxable year do not exceed $600,000 and (2) more than 50% of its receipts consist of premiums. Sec. 501(a), (c)(15)(A). Section 816(a) defines an insurance company as any company "more than half of the business of which during the taxable year is the issuing of insurance * * * or the reinsuring of risks underwritten by insurance companies."

Pursuant to section 953(d) a foreign insurance company that is a controlled foreign corporation, and which would qualify as an insurance company under subchapter L of the Code if it were a domestic corporation, may make an election to be treated as a domestic corporation for Federal income tax purposes. Reserve made an election under section 953(d) for the tax years in issue. It filed returns taking the position that it qualified as a tax-exempt insurance company under section 501(c)(15).

Generally, section 881(a) imposes a 30% tax on amounts received from sources within the United States by a foreign corporation as interest, dividends, rents, salaries, wages, premiums, annuities, compensations, remunerations, emoluments, and other fixed or determinable annual or periodical gains, profits, or income. This withholding tax is limited to the amount not effectively connected with the conduct of a trade or business within the United States. Sec. 881(a).

[*33] II. Insurance Requirements

Reserve contends that it was engaged in the business of issuing insurance and that it was a bona fide insurance company. Respondent contends that Reserve was not an insurance company because its arrangement with Peak and the other insureds was not insurance.

Neither the Code nor the regulations define insurance, and we are guided by caselaw in determining whether a particular transaction constitutes insurance for Federal income tax purposes. Avrahami v. Commissioner, 149 T.C. __, __ (slip op. at 49) (Aug. 21, 2017). Courts have looked to four criteria in deciding whether an arrangement constitutes insurance: (1) the arrangement involves insurable risks; (2) the arrangement shifts the risk of loss to the insurer; (3) the insurer distributes the risk among its policy holders; and (4) the arrangement is insurance in the commonly accepted sense. Harper Grp. v. Commissioner, 96 T.C. 45, 58 (1991), aff'd, 979 F.2d 1341 (9th Cir. 1992); AMERCO & Subs. v. Commissioner, 96 T.C. 18, 38 (1991), aff'd, 979 F.2d 162 (9th Cir. 1992). These four nonexclusive criteria establish a framework for determining the existence of insurance for Federal income tax purposes. AMERCO & Subs. v. Commissioner, 96 T.C. at 38. We consider all of the facts and circumstances in the light of the

[*34] criteria outlined above. See Rent-A-Center, Inc. v. Commissioner, 142 T.C. 1, 13-14 (2014). We will first look at the criterion of risk distribution.

A. Risk Distribution

Generally, risk distribution occurs when the insurer pools a sufficiently large number of unrelated risks. Id. at 24. From the insurer's perspective insurance is a risk-distribution device, a mechanism by which the insurer pools multiple risks of multiple insureds in order to take advantage of the "law of large numbers". R.V.I. Guar. Co. & Subs. v. Commissioner, 145 T.C. 209, 228 (2015). Insuring many independent risks for numerous premiums serves to distribute risk. Clougherty Packing Co. v. Commissioner, 811 F.2d 1297, 1300 (9th Cir. 1987), aff'g 84 T.C. 948 (1985). Risk distribution allows the insurer to reduce the possibility that a single claim will exceed the amount taken in as premiums and set aside for the payment of such a claim. Id.

In past cases we have focused on both the number of insureds and the total number of independent risk exposures to determine whether an insurer distributed risk. See Avrahami v. Commissioner, 149 T.C. at __ (slip op. at 64). We have held that a captive insurer may effectively distribute risk even though it insures only the risks of its commonly owned brother-sister entities. See Rent-A-Center,

[*35] Inc. v. Commissioner, 142 T.C. at 24; Securitas Holdings, Inc. v. Commissioner, T.C. Memo. 2014-225, at *26-*27.

In Rent-A-Center, Inc. v. Commissioner, 142 T.C. at 24, we concluded that the captive assumed and pooled premiums for "a sufficient number of statistically independent risks" and achieved risk distribution because it issued policies for its affiliates that covered more than 14,000 employees, 7,100 vehicles, and 2,600 stores in all 50 States. We found that the captive in Securitas Holdings v. Commissioner, at *26-*27, distributed risk effectively where it provided worker's compensation coverage for more than 300,000 employees, automobile coverage for more than 2,200 vehicles, and other coverages for more than 25 separate entities. By contrast, in Avrahami v. Commissioner, 149 T.C. at __ (slip op. at 65), we found that the captive's issuance of seven types of direct policies covering exposures for four related entities was insufficient to distribute risk.

1. Direct Written Policies

During the tax years in issue Reserve issued between 11 and 13 direct written policies for three insureds. According to Reserve, one company, Peak, was the primary insured under all of the policies, even though the policies listed Peak, Rocquest, and ZW. Peak operated two facilities in Osburn, had a maximum of 17 employees, and maintained some machinery used to repair and fabricate

[*36] mining equipment. It sold or serviced equipment used in 12 mines, and it sold some equipment outside the United States.

The record establishes that the operations of the other two insureds were insignificant. Only one document relating to either of these entities was included with the background documents that Capstone used to produce the feasability study. Rocquest owned real estate in three locations, all of which it leased to Peak or another entity partly owned by Zumbaum and Weikel, and it had no employees. ZW had no employees and owned no assets other than a small interest in a local bar.

Reserve issued direct written policies for the tax years in issue that covered between \$8 and \$13 million in potential losses, and most or all of the risk of loss was associated with the business operations of just one insured. We conclude that the number of insureds and the total number of independent exposures were too few to distribute the risk that Reserve assumed under the direct written policies. Like the taxpayer in Avrahami, Reserve in this case failed to achieve risk distribution through the policies that it issued for its affiliated entities. See id.

2. The Reinsurance Agreements

Reserve contends that it distributed risk through the stop loss endorsements and the quota share policies with PoolRe. During the tax years in issue around 55

[*37] Capstone entities executed these same contracts with PoolRe, and these contracts were referred to as the quota share arrangement. Under the quota share arrangement PoolRe gave stop loss endorsements for the captives' direct written policies and agreed to assume an excess portion of the risks associated with those policies. Simultaneously, the captives agreed to reinsure, and to receive premiums for reinsuring, a share of blended risk from PoolRe's stop loss pool. Reserve contends that pursuant to the quota share arrangement it "insured hundreds of unaffiliated insureds under hundreds of unaffiliated insurance policies."

Reserve contends that it distributed risk through the coinsurance contracts. According to the terms of these contracts it assumed liability for a fraction of the pool of vehicle service contracts that CreditRe ceded to PoolRe for the tax years in issue. Reserve contends that through the coinsurance contracts it earned premiums for assuming risks "related to a large pool of many thousands of risks".

Because of the payments that PoolRe agreed to make pursuant to the quota share arrangement and the payments called for under the coinsurance contracts, Reserve contends that over 30% of its gross premiums for each of the tax years in issue was from providing insurance to unrelated parties. Reserve cites Harper Grp. in support of its argument that its percentage of nonaffiliated premium income is sufficient to satisfy the requirements of risk distribution. In Harper Grp.

[*38] v. Commissioner, 96 T.C. at 59-60, we determined that the captive insurer distributed risk because, in addition to insuring affiliated entities, the captive provided coverage to and collected premiums from a "relatively large number of unrelated insureds". We considered the percentage of the captive's gross premiums that was derived from unrelated insurance business, and we found that approximately 30% of the captive's business came from insuring unrelated parties. Id. We concluded that this fact demonstrated that the captive had "a sufficient pool of insureds to provide risk distribution." Id. at 60.

In cases where we held that the captive insurer achieved risk distribution by insuring a sufficient number of unrelated parties, we also determined that the transactions with the unrelated parties were insurance transactions for Federal income tax purposes. Avrahami v. Commissioner, 149 T.C. at __ (slip op. at 66); see also Harper Grp. v. Commissioner, 96 T.C. at 59-60; AMERCO & Subs. v. Commissioner, 96 T.C. at 39-42. Before we can determine whether Reserve effectively distributed risk through these agreements, we must determine whether PoolRe was a bona fide insurance company. See Avrahami v. Commissioner, 149 T.C. at __ (slip op. at 66-67). In determining whether an entity is a bona fide insurance company we have considered a number of factors, including:

(1) whether it was created for legitimate nontax reasons;

[*39] (2) whether there was a circular flow of funds;

(3) whether the entity faced actual and insurable risk;

(4) whether the policies were arm's-length contracts;

(5) whether the entity charged actuarially determined premiums;

(6) whether comparable coverage was more expensive or even available;

(7) whether it was subject to regulatory control and met minimum statutory requirements;

(8) whether it was adequately capitalized; and

(9) whether it paid claims from a separately maintained account.

Id.; Rent-A-Center, Inc. v. Commissioner, 142 T.C. at 10-13. We address the most relevant factors in our analysis below.

PoolRe engaged in two sets of transactions during the tax years in issue: the quota share arrangement and the coinsurance contracts. We will consider the facts surrounding both in determining whether PoolRe was a bona fide insurance company.

a. Quota Share Arrangement

Capstone managed PoolRe, and only Capstone entities participated in the quota share arrangement. PoolRe had no employees. Reserve contends that PoolRe's stop loss pool was a mechanism whereby risks associated with the stop

[*40] loss endorsements were pooled and blended and that blended risk was ceded back to the Capstone entities. Reserve's expert Neil Doherty concluded that "virtually all the exposure assumed by any captive under the quota share reinsurance is entirely unrelated to the captive's affiliate".

Doherty explained that the pooled insurance risk of PoolRe is reinsured back to the Capstone captives on a proportional basis, which has the effect that the captives, such as Reserve, insure the smaller losses of their affiliates, but pool the larger losses so that each captive ends up bearing less than one-fiftieth of the larger loss. He concluded that this arrangement enabled Reserve to spread its risks across a large pool of unrelated parties, providing a wide distribution of risk.

Respondent contends that the quota share arrangement provided the appearance of risk distribution without actually distributing any risk. Respondent argues that PoolRe is not a bona fide insurance company because Reserve's arrangement with PoolRe did not distribute risk. Respondent argues that Reserve's arrangement with PoolRe did not distribute risk because PoolRe was not a bona fide insurance company.

i. Circular Flow of Funds

Under its quota share policies Reserve was to receive reinsurance premiums equal to the direct written premiums that its affiliated insureds owed PoolRe under

[*41] the stop loss endorsements. Reserve never recorded and it does not contend that it had any losses or expenses in connection with its purported quota share liabilities. Accordingly, the end result for each tax year under the quota share arrangement was that Reserve would receive payments from PoolRe in exactly the same amount as the payments that PoolRe was entitled to receive from Peak and the other insureds for the stop loss coverage. In considering a very similar set of circumstances in Avrahami v. Commissioner, 149 T.C. at __ (slip op. at 68), we concluded that "[w]hile not quite a complete loop, this arrangement looks suspiciously like a circular flow of funds."

ii. Arm's-Length Contracts

The perfect matching of payments under the corresponding stop loss endorsements and quota share policies (from insureds to PoolRe, and from PoolRe to captives) indicates that the quota share arrangement was not the product of arm's-length considerations. Peak's risks that were insured through PoolRe were different from the risks that PoolRe ceded to Reserve under the quota share policies. The risks that PoolRe purported to assume under the stop loss endorsements related to various unrelated business activities and to policies covering various unrelated lines of insurance. Reserve has not shown that the risks were comparable in scale.

[*42] The same amount that Peak and the other insureds were obligated to pay PoolRe for the stop loss coverage was to be paid to Reserve pursuant to the quota share arrangement. Reserve has not explained why these amounts were the same. It has not explained how all Capstone clients in the quota share arrangement would be able to transfer a particular set of risks (i.e., those associated with their affiliated insureds) and assume in exchange a blended portion of completely different risks for exactly the same premium price.

Reserve did not produce evidence which shows the risks of other Capstone entities. It did not provide evidence regarding their industries, locations, operations, types of risks, and exposure to risk. The evidence shows that the stop loss pool was divided among the captives so that reinsurance premiums equaled the portion of direct premiums paid by each captive's affiliated insureds. We conclude that the amounts that PoolRe was to pay Reserve under the quota share arrangement were not determined at arm's length or using objective criteria.

iii. Actuarially Determined Premiums

According to a letter from Glicksman Consulting, LLC, to Capstone, PoolRe charges premiums that are a flat percentage of the gross direct written premiums. Reserve produced no evidence to support the calculation of the premiums. There is no evidence regarding the other Capstone entities that

[*43] participated in the quota share arrangement which shows the industries and the risks involved and the specific amounts of exposure.

According to the evidence, all participants in the quota share arrangement agreed to direct their affiliated insureds to pay the same percentage of direct written premiums to PoolRe. As in Avrahami v. Commissioner, 149 T.C. at __ (slip op. at 69), we are concerned with a one-size-fits-all rate for all the participants in the quota share arrangement.

iv. Faced Actual and Insurable Risk

Under the terms of the direct written policies Reserve was liable for claims not covered by "any other valid and collectible insurance policy issued by any other insurer". Peak maintained extensive commercial insurance coverage with third-party insurers. Under the stop loss endorsements PoolRe was liable on claims made under the direct written policies only after a substantial claims threshold was exceeded.

Coverage under the stop loss endorsements was not triggered until claims reached 100% of total combined premiums in 2008 and 2009 and 35% of total combined premiums in 2010 (after which PoolRe would be obligated to pay 50% of claims made). The total combined premium amounts for the tax years in issue were $412,089, $448,127, and $445,314, respectively. Reserve could identify

[*44] only one occurrence before the tax years in issue when Peak tried to collect on an insurance claim with its third-party commercial insurers. EMC agreed to pay only $2,000 and Peak had to pay $25,000 for repairs to the damaged roof. This amount was significantly below the combined total premiums to be paid by the insureds for each tax year in issue and significantly below the claims threshold that would trigger PoolRe's liability under the stop loss endorsements.

Reserve cited the additional taxes that Peak paid after its returns were reviewed by an accounting firm, and it contends that this was a loss that the direct written policies and stop loss endorsements were designed to cover. However, Reserve provided no evidence of the amount of that purported loss or the likelihood that something like it would happen again. The available 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 provided for in the stop loss endorsements. PoolRe was removed far from any actual risk associated with the business or operations of Reserve's insureds.

v. <u>Licensed and Regulated as an Insurance Company</u>

Reserve provided evidence that PoolRe obtained a Class B insurance license after it redomiciled in Anguilla, starting April 15, 2009. However, it did not

[*45] provide evidence that PoolRe was a licensed and regulated insurer before that time. The record establishes only that PoolRe was a corporation in good standing in the British Virgin Islands before it reincorporated in Anguilla. Reserve executed both its 2008 and 2009 reinsurance agreements with PoolRe before it obtained an insurance license in Anguilla.

vi. Created for Legitimate Nontax Reasons

Reserve contends that PoolRe, through the quota share arrangement, operated for the purpose of distributing risk for the Capstone entities. All the facts and circumstances in this case indicate that Reserve did not enter into the quota share arrangement with the intention of distributing its risk. For each of the tax years in issue the arrangement cycled a portion of the premiums that Peak paid under the direct written policies from one controlled entity to another, Reserve, and Reserve was not taxed on the income pursuant to section 501(c)(15). The only purpose PoolRe served through the quota share arrangement was to shift income from Peak to Reserve. Reserve has not established that PoolRe was created or operated for legitimate nontax reasons.

vii. Conclusion

We conclude that the facts surrounding Reserve's quota share policies with PoolRe establish that those agreements were not bona fide insurance agreements.

[*46] The quota share arrangement involved a circular flow of funds. The premiums were not negotiated at arm's length. All the insureds of the participants in the quota share arrangement were obligated to pay the same percentage of premiums to PoolRe. There is no evidence that the premiums Peak and the other insureds were obligated to pay PoolRe and the premiums that PoolRe was obligated to pay Reserve were actuarially determined. PoolRe's activities as they relate to those policies were not those of a bona fide insurance company.

b. Coinsurance Contracts

The risks associated with the coinsurance contracts purportedly related to a large pool of vehicle service contracts that a large insurance provider had originally underwritten. According to documents that Reserve provided and testimony of its witnesses, the liabilities for these vehicle service contracts were pooled and ceded down a chain of entities, and ultimately CreditRe ceded a portion of the pooled risk to PoolRe. The coinsurance contracts provided that PoolRe ceded portions of its liability for the vehicle service contracts to Reserve.

Reserve contends that liability for the pool of vehicle service contracts generated losses that offset premiums received during the tax years in issue. It failed to provide evidence that the vehicle service contracts, which formed the basis for the reinsurance that PoolRe re-ceded in the coinsurance contracts,

[*47] actually existed. Fagg described a series of ceding transactions (i.e., from Lyndon to ARIA, from ARIA to CreditRe, and from CreditRe to PoolRe). Even if we agree with Reserve about the validity of the coinsurance contracts, any actual risk that PoolRe had in connection with the vehicle service contracts was de minimis, because PoolRe assumed liability for a small, blended portion of the overall pool of vehicle service contracts, and it re-ceded most or all of that liability to the Capstone entities. The amount ceded to Reserve was also de minimis.

On the basis of the relevant facts and circumstances we conclude that the coinsurance contracts were not bona fide reinsurance agreements. Reserve has not established that the contracts underlying the purported reinsurance transactions existed or that the transactions involved actual risk.

c. Conclusion

We conclude that PoolRe was not a bona fide insurance company. The purported reinsurance agreements between it and Reserve did not allow Reserve to effectively distribute risk. Neither through the policies it issued for its affiliated entities nor through its agreements with PoolRe did Reserve achieve risk distribution. Risk distribution is a necessary component of insurance, and its absence in this case is sufficient for us to conclude that Reserve's transactions during the tax years in issue were not insurance transactions. See Avrahami v.

[*48] Commissioner, 149 T.C. at __ (slip op. at 76); see also AMERCO & Subs. v. Commissioner, 96 T.C. at 40 (holding that risk-shifting and risk-distributing "are necessary to the existence of insurance" (citing Gulf Oil Corp. v. Commissioner, 89 T.C. 1010, 1023 (1987), aff'd, 914 F.2d 396 (3d Cir. 1990))).

B. Insurance in the Commonly Accepted Sense

The absence of risk distribution is enough to conclude that the transactions between Reserve and its insureds were not insurance transactions. An alternative ground for this holding is that they did not constitute insurance in the commonly accepted sense. See Avrahami v. Commissioner, 149 T.C. at __ (slip op. at 76). To determine whether an arrangement constitutes insurance in its commonly accepted sense we look at a number of 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; whether the premiums were reasonable and the result of an arm's-length transaction; and whether claims were paid. R.V.I. Guar. Co. & Subs. v. Commissioner, 145 T.C. at 231; Rent-A-Center, Inc. v. Commissioner, 142 T.C. at 24-25; Harper Grp. v. Commissioner, 96 T.C. at 60.

Reserve contends that it was formed for a valid business purpose, the issuance of insurance contracts. It further contends that each of the contracts at

[*49] issue meets all the requirements for an arrangement that constitutes insurance in the commonly accepted sense. In support of its argument Reserve contends that we should consider 39 determination letters that the Commissioner issued to other unrelated taxpayers concerning tax-exempt status under section 501(c)(15). Reserve contends that its captive insurance arrangement is similar to the 39 other arrangements for which the Feldman firm received approval of an application for tax-exempt status.

Respondent contends that Reserve did not provide insurance in the commonly accepted sense. Respondent further contends that Peak's premium payments to Reserve were made at the direction of Zumbaum and Weikel in order to reduce Peak's profits.

We will not rely upon the 39 determination letters in our consideration of whether Reserve offered insurance in the commonly accepted sense. These determinations cannot be used as precedent, see sec. 6110(k)(3), but they may be instructive for revealing the "interpretation put upon the statute by the agency charged with responsibility of administering the revenue laws", Hanover Bank v. Commissioner, 369 U.S. 672, 686 (1962).

[*50] 1. Organization, Operation, and Regulation

Reserve was incorporated as an insurance company in Anguilla, and it was regulated by the Financial Services Commission of Anguilla. Generally, it complied with the requirements of Anguillan law. It obtained an insurance license, filed financial statements with regulators, satisfied minimum capitalization requirements, and maintained a business address in Anguilla. Apart from observing these formalities, however, the facts demonstrate that Reserve was not operated as an insurance company.

Reserve's planning, incorporation, and operations during the tax years in issue were managed entirely by Capstone. Reserve had no employees of its own that performed services. Zumbaum, Reserve's 50% owner, president, and chief executive officer, knew virtually nothing about its operations. At trial he showed very little knowledge of provisions in the policies that Peak and his other entities held with Reserve. Zumbaum did not know how claims were made or handled, and he did not know where or how Reserve's records were kept. Reserve's operations were managed at Capstone's direction. It maintained an address in Anguilla, but there is no evidence that any activities were ever performed there.

Other than the feasibility study that Capstone produced, there is no evidence that any due diligence was performed for the policies that Reserve issued. The

[*51] feasibility study gave an overview of Peak's operations, and some background documents relating to Peak's operations were attached to the feasibility study. However, many of the background documents covered periods after Reserve's incorporation. The feasibility study was not complete when Reserve issued the direct written policies for 2008 or 2009. The feasibility study did not provide details about the other insureds, Rocquest and ZW, and they were parties under every policy that Reserve issued. These two entities were named as insureds on policies that did not seem to apply to their limited activities.

There is no evidence that Reserve performed any due diligence with respect to the reinsurance agreements that it executed with PoolRe. With respect to the quota share arrangement it agreed to assume risks relating to a number of different businesses and a number of different lines of insurance. Nothing in the record indicates that Reserve or anyone performing activities on Reserve's behalf evaluated these risks before executing the quota share policies.

Capstone managed both Reserve and PoolRe, and they were both parties to the quota share policies and the coinsurance contracts. Reserve contends that the reinsurance agreements allowed it to distribute risk. However, Reserve did not show that anyone with a financial interest in its operations considered the details of the quota share policies and the coinsurance contracts and considered whether

[*52] risk was distributed. Zumbaum did not understand the details of Reserve's operations and relied upon Capstone's advice. There is no evidence that Reserve engaged in any due diligence to determine whether it was adequately distributing risk.

Only one claim was filed under Reserve's direct written policies. A claim notice was generated for the Stillwater loss, but no supporting documentation accompanied the claim notice. Peak did not submit and Reserve did not insist on obtaining any documents to substantiate the occurrence or the amount of the claimed loss. The first payment for the Stillwater loss was made out of Reserve's bank account more than a month before Reserve and Peak executed the settlement and release agreement. Peak received another large payment out of Reserve's bank account several months after the execution of the settlement and release agreement. Reserve did not execute an addendum to the settlement and release agreement reflecting this payment until years after the tax years in issue. All payments for the Stillwater loss were made by checks that Howard, a Peak employee, signed.

In considering whether Reserve operated as an insurance company, we "look beyond the formalities and consider the realities of the purported insurance transactions". Hosp. Corp. of Am. v. Commissioner, T.C. Memo. 1997-482, slip

[*53] op. at 59 (citing Malone & Hyde, Inc. v. Commissioner, 62 F.3d 835, 842-843 (6th Cir. 1995), rev'g T.C. Memo. 1989-604). In reality the interested parties to Reserve's insurance transactions did not participate in structuring or executing those transactions; little or no due diligence was performed with respect to the direct written policies or the reinsurance agreements; and for all of the tax years in issue only one claim was filed under Reserve's policies, and that claim was handled in an irregular manner. Capstone directed Reserve's activities and directed a series of transactions between its managed entities so that Reserve appeared to be engaged in the business of issuing insurance contracts. The facts establish that Reserve was not operated as an insurance company in the commonly accepted sense.

2. Adequate Capitalization

During the tax years in issue Reserve met the minimum capitalization requirements of Anguilla. Generally our caselaw holds that meeting the statutory requirements of the captive's domicile jurisdiction is sufficient to show that the captive was adequately capitalized. See Avrahami v. Commissioner, 149 T.C. at __ (slip op. at 80-81); R.V.I. Guar. Co. & Subs. v. Commissioner, 145 T.C. at 231; Rent-A-Center, Inc. v. Commissioner, 142 T.C. at 13, 23-24; Harper Grp. v. Commissioner, 96 T.C. at 50, 60.

[*54] 3. Valid and Binding Policies

To be valid and binding an insurance policy should, at a minimum, identify the insured, define an effective period for the policy, specify what is covered by the policy, state the premium amount, and be signed by authorized representatives of the parties. See Avrahami v. Commissioner, 149 T.C. at __ (slip op. at 81); Securitas Holdings v. Commissioner, at *28. In R.V.I. Guar. Co. & Subs. v. Commissioner, 145 T.C. at 231, we held that policies were valid and binding where the insureds filed claims for all covered losses and the captive paid them.

Generally, Reserve's direct written policies contained the necessary terms to make them valid and binding insurance, and they were signed by representatives of Reserve and the insureds. We agree with respondent, however, that the direct written policies were "cookie cutter" policies. The policies on their face indicate that they were the copyrighted material of Capstone, and Capstone employees testified at trial that they administered many of the same policies for all of their clients. In many instances the policies were not reasonably suited to the needs of the insureds, particularly Rocquest and ZW, both of which had extremely limited operations.

Peak did file one claim under one of the direct written policies, and Reserve paid the claim. However, the evidence of this claim that Reserve provided does

[*55] not show that either party performed due diligence to determine whether the claim was actually covered by the relevant policy. Payment of the claim on Reserve's behalf was handled by an employee of Peak. Evidence regarding the validity of Peak's policies is mixed, and we conclude it is a neutral factor.

4. Reasonableness of Premiums

Reserve put forward experts to opine that the premiums charged for its direct written policies during the tax years in issue were reasonable. Capstone employees, particularly McNeel, were responsible for determining the premium amounts for the policies. Zumbaum and Weikel always approved the amounts that Capstone advised, and Zumbaum testified that he was aware that the amounts would generate substantial deductions for Peak.

In preparing the rating worksheets for Reserve's policies, McNeel used rating bases specific to Peak's business, and he applied base rates that were within ranges shown on Capstone's base rate spreadsheet. McNeel produced the base rate spreadsheet by reviewing the premiums that other Capstone entities had charged for various lines of coverage. Capstone obtained pricing indications from employees of Mid-Continent. McNeel testified that these indications were critical to Capstone's pricing methodology and were used to establish the base rates for policies shown on the base rate spreadsheet.

[*56] Despite the methodology that Reserve has shown Capstone used internally to calculate premiums, there are a number of factors which indicate that the premiums that the insureds were required to pay under the direct written policies were not reasonable in relation to the risk of loss. For 2007 Peak paid insurance expenses of $95,828. For 2008 Peak and two affiliates that had no active business operations were obligated to pay premiums of $412,089, and this was in addition to the premiums that Peak continued to pay for third-party commercial insurance. Reserve's policies covered only losses that were not covered by Peak's third-party policies. Peak's general liability policy with EMC had a policy limit of $2 million and covered several major categories of risks, including personal injury and products/completed operations liability.

Seven of the 2008 policies had retroactive dates. For 2008 the punitive wrap liability policy was retroactive, and it had a combined premium of $55,233 and a policy limit of $1 million. For both 2009 and 2010 the premium for the punitive wrap liability policy was $40,500 and the aggregate coverage was $500,000. Reserve provided no explanation as to why the policy limit was decreased to $500,000 and why a policy for four years with greater coverage cost only approximately $15,000 more than a policy for one year with half the coverage.

[*57] Six of the 2008 policies had no look-back provisions. For 2008 the regulatory changes policy had a policy period from December 4, 2008, to January 1, 2009, and the premium was $64,899 and the policy limit was $1 million. For both 2009 and 2010 the premium for the regulatory changes policy had a premium of $47,588 and a limit of $500,000. Reserve provided no explanation for why the limit was reduced from $1 million for one month of coverage to $500,000 for a year of coverage. It also provided no explanation why more was spent for one month of insurance coverage than a year of coverage.

Reserve contends that Peak was on a Superfund site and could have been exposed to pollution liability, for which no third-party coverage was available. Peak itself did not engage in mining practices that spread pollutants, and it already had systems in place to control the fluid runoff when it cleaned equipment used in polluted mines. In 2008 Peak had operated in Osburn continuously for over 10 years. Reserve provided no evidence that Peak had ever incurred costs during that time for excess pollution liability.

In his testimony Zumbaum indicated that EMC's refusal in 2007 to cover the full amount needed to repair Peak's damaged roof was a reason for obtaining additional insurance in 2008. He testified that Peak incurred a $25,000 expense to repair the roof, although no documentation was produced to substantiate the

[*58] amount of the loss. Zumbaum also testified about having to pay additional taxes for tax years prior to the tax years in issue. His testimony did not include how much additional tax was owed.

Despite Zumbaum's purported discontent with EMC's coverage, Peak subsequently kept its policies with EMC. Reserve has failed to explain why Peak would maintain its full set of third-party commercial insurance coverage, which it contends was insufficient, even after it paid roughly 400% more for additional coverage from Reserve. Zumbaum did not know which of Peak's policies with Reserve would have covered a loss like the one that was not covered by EMC in February 2008.

Zumbaum testified that in 2007 Peak's business was growing and that he expected it to continue growing during the next few years. He testified that he and Weikel had concerns about additional risks as the business grew. However, the rating worksheets that Capstone produced for calculating Reserve's premiums reflect that Peak's projected sales stayed the same for all of the tax years in issue. Peak actually had fewer employees in 2010 than it did in 2008.

Reserve contends that if one of Peak's products had failed then Peak would have been liable. There is no convincing evidence that legitimate concerns about this kind of liability should have been greater in 2008 than in previous years, and

[*59] during the tax years in issue Peak continued to maintain substantial commercial insurance coverage with third-party insurers. The feasibility study provided no information on the probability of a loss event that the direct written policies covered. It also did not explain in detail how the direct written policies would supplement Peak's existing insurance.

Peak filed only one claim under Reserve's policies during the tax years in issue, which occurred about one month after Reserve's incorporation. For the remainder of the tax years in issue Peak and the other insureds did not file any claims or report any additional losses. This supports our conclusion that any purported concerns about increased risks for the insureds were unfounded.

In cases involving brother-sister captive arrangements in which we determined that the premiums charged were reasonable, we have also found that the arrangement under scrutiny was undertaken principally to achieve a business purpose. See, e.g., Rent-A-Center, Inc. v. Commissioner, 142 T.C. at 3-5 (the principal objective of the arrangement was to reduce costs, improve efficiency, obtain otherwise unavailable coverage, and provide accountability and transparency); Securitas Holdings v. Commissioner, at *7-*8 (finding the captive insurance arrangement at issue provided more cost-effective insurance coverage than would have otherwise been available). Generally, we conclude that

[*60] premiums are reasonable when it can be shown that the amounts agreed upon by the parties were the result of arm's-length negotiations. See R.V.I. Guar. Co. & Subs. v. Commissioner, 145 T.C. at 231-232; Harper Grp. v. Commissioner, 96 T.C. at 60. In determining whether an arrangement constitutes insurance in the commonly accepted sense we consider more than whether the premiums chosen can be arrived at by actuarial means. We consider whether the facts demonstrate that the terms of the arrangement were driven by arm's-length considerations. See R.V.I. Guar. Co. & Subs. v. Commissioner, 145 T.C. at 234-235 (finding the subject policies constituted insurance in the commonly accepted sense because the policies' terms "correspond to, and are driven by, the characteristics and business needs of the underlying * * * transactions").

The facts do not reflect that Peak had a genuine need for acquiring additional insurance during the tax years in issue. There was no significant history of losses that would justify such a drastic increase, and Zumbaum's testimony that he was concerned about increased risks beginning in 2008 did not support a significant increase in insurance coverage. All the direct written policies included a provision that the coverage afforded by the policy would be valid only after insurance coverage from other insurers was exhausted. Peak had never come close to exhausting the policy limits of its third-party commercial insurance coverage.

[*61] With respect to premiums, the facts and circumstances of this case demonstrate that the direct written policies were not the result of arm's-length negotiations. Taking into consideration all the surrounding facts and circumstances, we conclude that no unrelated party would reasonably agree to pay Reserve the premiums that Peak and the other insureds did for the coverage provided by the direct written policies. Although Capstone calculated Reserve's premiums using objective criteria and what appear to be actuarial methods, the absence of a real business purpose for Reserve's policies leads us to conclude that the premiums paid for the polices were not reasonable and not negotiated at arm's length.

5. Payment of Claims

Reserve paid the one claim that Peak filed during the tax years in issue. As we noted in connection with other factors, the circumstances surrounding the payment of that claim were unusual. Although this factor weighs slightly in Reserve's favor, we do not regard the payments made in connection with the Stillwater loss as overwhelming evidence that Reserve's direct written or reinsurance policies constituted insurance in the commonly accepted sense.

[*62] 6. Conclusion

Reserve was organized and regulated as an insurance company, and it satisfied the regulatory requirements of its domicile jurisdiction. It also paid a claim filed under one of its policies. However, it was not operated as a bona fide insurance company, and there was no legitimate business purpose for the policies that Reserve issued for the insureds. The direct written policies increased Peak's insurance coverage and expenses for the tax years in issue, when it also continued to hold policies with third-party insurers. In the light of all the facts and circumstances the premiums charged for the policies were unreasonable. We conclude that Reserve's transactions were not insurance transactions in the commonly accepted sense.[3]

III. Taxability of Reserve's Revenue

We concluded that Reserve did not issue insurance or reinsurance contracts during the tax years in issue and therefore it did not receive more than 50% of its gross receipts from insurance premiums. See secs. 501(c)(15), 816(a). Because Reserve is not an insurance company, it is not eligible to make an election under section 953(d). Section 953(d) applies only to a foreign company which would

[3]Since we conclude Reserve's transactions were not insurance transactions, we do not need to address respondent's argument that Reserve's insurance and reinsurance arrangements lack economic substance.

[*63] qualify as an insurance company under subchapter L of the Code if it were a domestic corporation. See sec. 953(d)(1)(B).

Because Reserve was not eligible to make an election under section 953(d), for the tax years in issue it should be treated as a foreign corporation. See sec. 953(d). For each of the tax years in issue Reserve reported the gross premiums for the direct written policies and the reinsurance agreements as program service revenue on Forms 990. For each of the tax years in issue Reserve also reported revenue from investment income, and for 2009 and 2010 it reported "other revenue".

Section 881(a)(1) generally imposes a tax of 30% on "fixed or determinable annual or periodical" income (FDAP income) received by a foreign corporation from sources within the United States if the income is not effectively connected with the conduct of a U.S. trade or business. FDAP income includes interest, dividends, rents, salaries, wages, premiums, annuities, compensations, remunerations, and emoluments. Sec. 881(a)(1). It includes all income included in gross income under section 61, except for items specifically excluded by the regulations. Sec. 1.1441-2(b)(1)(i), Income Tax Regs. The U.S. payors of FDAP income are generally required to deduct and withhold therefrom an amount equal to the tax imposed by sections 881. See secs. 1441 and 1442.

[*64] In the notice respondent determined that the amounts reported as Reserve's program service revenue were taxable as FDAP income from sources within the United States and were subject to the 30% withholding tax pursuant to section 881. Respondent conceded that the withholding tax should not apply to the amounts for the tax years in issue which Reserve contends were gross premiums received for the coinsurance contracts, which are $69,500, $76,500, and $66,000, respectively. Respondent maintains that the remainder of Reserve's self-reported program service revenue is taxable under section 881.

Reserve contends that if the payments it received for the tax years in issue were not for insurance, then amounts received from its affiliated insureds should be treated as contributions to capital or nontaxable advances or deposits. It contends that if we conclude that it had taxable revenue, then it is entitled to deductions in computing its taxable income.

Reserve bears the burden of showing that the income it received is not FDAP income as respondent determined in the notice. See Rule 142(a). Reserve did not produce evidence which showed that the amounts at issue are not FDAP income subject to the 30% tax. We reject Reserve's contention that the amounts it received during the tax years in issue were capital contributions or nontaxable deposits.

[*65] Zumbaum and Weikel capitalized Reserve shortly after its organization with $100,000, as required by Anguillan law. The record does not reflect that the parties to the purported insurance transactions treated or intended the amounts paid to Reserve as additional capital contributions. See Bd. of Trade v. Commissioner, 106 T.C. 369, 381 (1996) (holding that a payor's motive controls whether a payment is a contribution to capital). Reserve failed to specify why the payments might otherwise be treated as nontaxable deposits. There is no evidence indicating that the parties intended the payments as loans or gifts. See Neely v. Commissioner, 85 T.C. 934, 952 (1985) (holding that the most critical consideration in determining whether a transfer is a gift is the transferor's intention); Beaver v. Commissioner, 55 T.C. 85, 91 (1970) (holding that an essential element of a loan is that the recipient intends to make repayment and the person advancing the funds intends to enforce such repayment).

Reserve contends it should be allowed deductions for the tax years in issue. It bears the burden of proof on this issue. See INDOPCO, Inc. v. Commissioner, 503 U.S. 79, 84 (1992); New Colonial Ice Co. v. Helvering, 292 U.S. 435, 440 (1934). It contends that under section 1.882-4(a)(3)(ii), Income Tax Regs., it had reasonable cause for filing Forms 990 rather than Forms 1120-F.

[*66] However, even if Reserve established that it had reasonable cause for filing incorrect returns, we would not conclude that it is entitled to deductions. Section 1.882-4(b)(1), Income Tax Regs., provides generally that deductions are allowed to a foreign corporation only to the extent they are connected with gross income which is effectively connected, or treated as effectively connected, with the conduct of a trade or business in the United States. Reserve failed to establish that it was engaged in or received income treated as income effectively connected with a trade or business within the United States.

We sustain respondent's determination in the notice that for the tax years in issue Reserve had FDAP income from sources within the United States which is subject to the 30% tax under section 881. Reserve has not met its burden of proving its entitlement to any deductions.

To reflect the foregoing,

Decision will be entered under Rule 155.

Attachment B

Tax Court's

September 28, 2018 Decision

UNITED STATES TAX COURT
WASHINGTON, DC 20217

DRC

RESERVE MECHANICAL CORP. F.K.A. RESERVE CASUALTY CORP.,	)	
Petitioner(s),	)	
v.	)	Docket No. 14545-16.
COMMISSIONER OF INTERNAL REVENUE,	)	
Respondent	)	

DECISION

Pursuant to the determination of the Court, as set forth in its Memorandum Findings of Fact and Opinion (T.C. Memo. 2018-86), filed June 18, 2018, and incorporating herein the facts recited in respondent's computations as the findings of the Court, it is

ORDERED AND DECIDED that there are deficiencies in income tax due from petitioner for the taxable years 2008, 2009, and 2010 in the amounts of $123,688.00, $141,468.00, and $148,505.00, respectively.

(Signed) Kathleen Kerrigan
Judge

Entered: **SEP 28 2018**

SERVED Sep 28 2018

Addenda

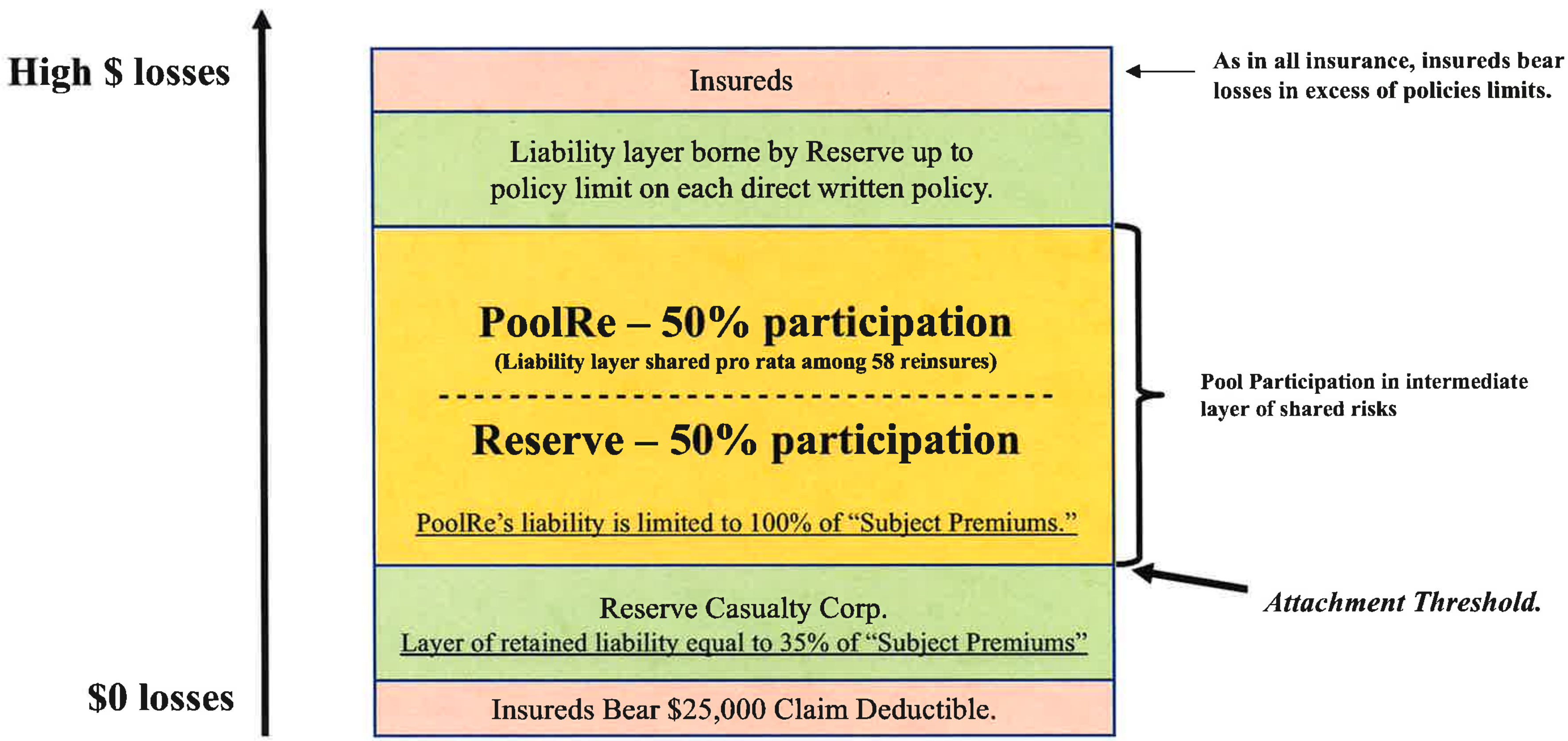
(Diagrams A and B)

Addendum A

Diagram A

Layering of Risk in Reserve's Insurance Program (2010)

Diagram A – Layering of Risk in Reserve's Insurance Program (2010)



PoolRe Acts as Pool Administrator, Passing Through Risks: PoolRe acts as the "Administrator" by (i) participating in the policies' underwriting, (ii) pooling the risks and ceding all liability under the pooled policies, and (iii) blending the risks, which are ceded on a quota share basis to the 58 "Ultimate Reinsurers." **See App.Vol.12.p.3546-7**.

Pass Through of Risks to Ultimate Reinsurers: PoolRe cedes all risks to the 58 Reinsurers (that is, the pool participants, each being a regulated insurer), which collectively assume all risks from PoolRe. The insureds agree to look solely to the 58 Reinsurers for all risks on the pooled policies. **See App.Vol.12.p.3546-7**.

Attachment Threshold: PoolRe (as the "Stop Loss Insurer") has no liability to pay claims from the pool until the total of all claims reported by the Insureds exceed 35% of the "Subject Premiums" for all policies specified in the "Joint Underwriting Stop Loss Endorsement." **See App.Vol.12.p.3545**. In the case of Reserve for 2010, the attachment threshold was $155,860.

"Subject Premiums": Defined as the sum of the premiums paid by the Named Insureds to both Reserve (the "Lead Insurer") and PoolRe (the "Stop Loss Insurer"). **See App.Vol.12.p.3550**. The total amount of Subject Premiums in 2010 was $445,314. **See App.Vol.12.p. 3422-3424**.

Addendum B

Diagram B

Three Diversifying Insurance Programs (2010)

Diagram B – Three Diversifying Insurance Programs (2010)