# 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**

**ORAL ARGUMENT REQUESTED**

**ON APPEAL FROM THE DECISION OF THE TAX COURT**
**No. 14545-16**
**JUDGE KATHLEEN KERRIGAN**

## BRIEF FOR THE APPELLEE

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# GLOSSARY

| **Abbreviation** | **Definition** |
|---|---|
| the affiliated insureds | Peak, RocQuest, and ZW |
| Amicus | Brief submitted by 10 trade organizations and one professional association as *amici curiae* |
| Br. | Taxpayer's opening brief on appeal |
| Capstone | Capstone Associated Services, Ltd. |
| CreditRe | Credit Reassurance Corporation, Ltd. |
| FDAP income | fixed or determinable annual or periodic income, the receipt of which from U.S. sources by a foreign corporation may be subject to the 30-percent tax imposed by I.R.C. § 881(a) |
| I.R.C. | Internal Revenue Code (26 U.S.C.) |
| IRS | Internal Revenue Service |
| Peak | Peak Mechanical & Components, Inc. |
| PoolRe | PoolRe Insurance Corp. |
| RocQuest | RocQuest, LLC |
| taxpayer | petitioner-appellant Reserve Mechanical Corp. |
| ZW | ZW Enterprises, LLC |

## STATEMENT OF RELATED CASES

Pursuant to Tenth Circuit Rule 28.2(C)(1), counsel for the Commissioner state that there are no prior or related appeals.

## JURISDICTIONAL STATEMENT

On March 29, 2016, the Internal Revenue Service ("IRS") mailed a notice of deficiency to Reserve Mechanical Corp., formerly known as Reserve Casualty Corp. ("taxpayer"), pursuant to Section 6212 of the Internal Revenue Code (26 U.S.C.) ("I.R.C."), determining deficiencies in federal income taxes for 2008, 2009, and 2010. (App.Vol.1.p.15-21.) On June 24, 2016, taxpayer filed a timely petition in the Tax Court. (App.Vol.1.p.1-14; I.R.C. § 6213(a).) The Tax Court had jurisdiction under I.R.C. §§ 6213, 6214, and 7422.

The Tax Court entered a final decision disposing of all claims on September 28, 2018. (App.Vol.4.p.1003.) On December 20, 2018, taxpayer filed a timely notice of appeal. (App.Vol.4.p.1004-06); I.R.C. § 7483; Fed. R. App. P. 13(a)(1)(A). This Court has jurisdiction under I.R.C. § 7482(a)(1).

## STATEMENT OF THE ISSUES

1. Whether the Tax Court correctly determined that taxpayer did not qualify as an insurance company for federal tax purposes during the years at issue, such that it was not a tax-exempt organization described in I.R.C. § 501(c)(15).

2. Whether the Tax Court correctly determined that amounts reported on taxpayer's tax returns as income were, in fact, income and therefore subject to the tax imposed by I.R.C. § 881(a).

## STATEMENT OF THE CASE

### A. The nature of the case and course of proceedings in the Tax Court

This case arises from the formation of taxpayer, an Anguilla-based corporation indirectly owned by Idaho businessmen Norman Zumbaum and Corey Weikel, for the ostensible purpose of providing insurance to their three U.S. entities: Peak Mechanical & Components, Inc. ("Peak"), RocQuest, LLC ("RocQuest"), and ZW Enterprises, LLC ("ZW").[1] Collectively, we refer to these U.S. entities as "the affiliated insureds."

Taxpayer filed U.S. tax returns for 2008, 2009, and 2010, representing that it was a small insurance company exempt from U.S. tax under I.R.C. § 501(c)(15). Following an examination, the IRS determined that taxpayer's arrangements were not insurance and that

[1] For convenience, we use the terms insurance, reinsurance, etc., as they are used in the relevant documents and testimony. Our use of these terms is not a concession that the arrangements actually constitute insurance.

taxpayer was therefore not a tax-exempt insurance company. The IRS subsequently issued a notice of deficiency to taxpayer determining unreported tax for 2008, 2009, and 2010.

Taxpayer filed a petition in the Tax Court. The court held a four-day trial, after which it issued a memorandum opinion largely sustaining the IRS's determination. (T.C. Memo. 2018-86; App.Vol.3.p.850-900; App.Vol.4.p.901-15.) In accordance with that opinion, the court entered a decision that taxpayer had income tax deficiencies of $123,688, $141,468, and $148,505 for 2008, 2009, and 2010, respectively (App.Vol.4.p.1003).

### B. Small captive insurance arrangements and the potential for abuse

Insurance generally involves an insurer entering into a contract with a third party, wherein the insurer agrees to compensate that party (the insured) if it experiences a loss from a specified risk. *Black's Law Dictionary* (11th ed. 2019). In exchange for such coverage, the insured pays the insurer an agreed-upon premium. *Id.*

Conventional insurance arrangements occur through the commercial marketplace, where the insurer and insured are unrelated parties negotiating at arm's-length, and the insured has no interest in,

or control over, the premiums after remitting them to the insurer. Accordingly, although the insured may claim a deduction under I.R.C. § 162 for premiums paid, the insured has no incentive – tax or otherwise – to purchase unnecessary coverage or pay premiums in excess of fair market value. "'[F]rom the standpoint of the insured there can be no profit from'" the risk covered by the insurance. (Amicus 9 (quoting *AMERCO, Inc. v. Commissioner*, 979 F.2d 162, 167 (9th Cir. 1992).) That is, even if the event insured against never occurs (or occurs and the resulting loss is fully covered by the insurance), the insured will still be poorer by the amount of the premium paid.

By contrast, in so-called "captive" insurance arrangements, the insurer and insured are affiliated parties. (App.Vol.5.p.1372.) Both the IRS and practitioners agree that, in the context of small captives, there is significant potential for tax abuse. IR-2019-47, 2019 WL 1315195, at *1-*2; *CIC Servs., LLC v. Internal Revenue Serv.*, 2017 WL 6016526, at *2 (E.D. Tenn. Apr. 21, 2017) (unpublished).

Such abuse can occur where one or more affiliated insureds pay (often excessive) premiums to a captive insurer for insurance that they do not really need. Notice 2016-66, 2016-47 I.R.B. 745, at § 1.02. On

the insureds' side, this generates large deductions and thereby decreases their current taxable income. *Id.* at § 1.04. On the captive's side, income is exempt from tax as long as gross receipts for the taxable year do not exceed $600,000 and more than 50 percent of such gross receipts consist of premiums. I.R.C. § 501(c)(15).[2] Because the insureds and the insurer are under common control, the insureds (or their owners) never really lose control of the funds. Notice 2016-66 at § 1.04. And although the insurer may nominally provide insurance to unrelated parties, abusive arrangements are structured so that there is little or no risk that the insurer will have to pay any significant loss suffered by such parties. *Id.* at § 1.03.

**C. The relevant facts**

**1. Zumbaum, Weikel, and their businesses**

Zumbaum and Weikel were 50-percent co-owners of the affiliated insureds, each of which had its principal place of business in Osburn, Idaho. (App.Vol.2.p.369-70.) Peak was formed around 1996; it manufactured, repaired, and serviced equipment that other businesses

[2] Certain small insurance companies that fail to qualify under § 501(c)(15) may qualify for a less favorable tax break under § 831(b).

used for underground mining and construction. (App.Vol.2.p.370-71; App.Vol.4.p.1118.) RocQuest held title to the land on which Peak operated, some of which was located within a polluted area designated a "Superfund Site." (App.Vol.4.p.1120.) ZW provided financing for a former Peak employee to purchase a bar. (App.Vol.4.p.1120.)

Of these entities, only Peak had either significant operations or employees. (App.Vol.3.p.885.) Peak historically maintained six commercial insurance policies (including general liability, commercial property, and worker's compensation policies), for which it paid premiums of $38,810, $95,828, and $57,300 in 2006, 2007, and the first half of 2008, respectively. (App.Vol.10.p.2725, 2738, 2757.) During the years at issue, Peak continued to maintain all its commercial policies. (App.Vol.4.p.1132.)

### 2. Taxpayer is formed and issues insurance to the affiliated insureds

Zumbaum and Weikel asked a captive-insurance promoter and manager, Capstone Associated Services, Ltd. ("Capstone"), to examine the feasibility of forming a captive to provide additional insurance for their businesses. (App.Vol.4.p.1124; App.Vol.5.p.1368; App.Vol.6.p.1528.) After Capstone conducted a site visit in

August 2008, Zumbaum and Weikel (a) formed taxpayer as an Anguillan corporation, which they indirectly owned through a Nevada holding company, and (b) applied for an Anguillan insurance license for taxpayer. (App.Vol.2.p.363, 366-67; App.Vol.7.p.1823-83, 2027.)

In December 2008, one day after receiving its insurance license, taxpayer issued 13 direct-written insurance policies (including cyber risk, intellectual property, and public-relations-expense-reimbursement policies) covering the affiliated insureds through the end of the year, for which they paid $412,089 in premiums. (App.Vol.7.p.1885; App.Vol.11.p.3107-3241.) Six of those policies provided one month of coverage, and seven provided coverage retroactive to January 2005. (App.Vol.11.p.3110-241.) Each of the policies provided $1 million of coverage. (App.Vol.3.p.866.)

In January 2009, taxpayer issued 11 direct-written policies covering the affiliated insureds, for which they paid $448,127 in premiums. (App.Vol.11.p.3284-86.) Five of the policies provided $1 million of coverage apiece, and six provided $500,000 of coverage apiece. (App.Vol.3.p.868.)

In August 2009, Capstone completed a feasibility study recommending that Peak form an Anguilla-based captive. (App.Vol.5.p.1254; App.Vol.7.p.2027-81.) The study did not provide detailed analysis of the insurance needs of Peak or the other affiliated insureds (App.Vol.7.p.2031, 2033), although it repeatedly stated that Peak was willing to pay "'platinum-level premiums'" for "'platinum-level coverage'" (App.Vol.7.p.2051, 2063, 2074-75). Also in August 2009, taxpayer submitted an application for recognition of exempt status to the IRS, representing that it was a small insurance company under I.R.C. § 501(c)(15). (App.Vol.8.p.2113-398.)

In January 2010, taxpayer issued 11 direct-written policies covering the affiliated insureds, for which they paid $445,314 in premiums. (App.Vol.12.p.3422-24.) As was the case with the 2009 policies, five of the policies provided $1 million of coverage apiece, and six provided $500,000 of coverage apiece. (App.Vol.3.p.869.)

### 3. Taxpayer's operations and oversight

Taxpayer had no employees. (App.Vol.6.p.1596, 1615, 1653.) It outsourced operations and oversight to (a) Capstone and (b) PoolRe Insurance Corp. ("PoolRe"), an Anguillan entity that, like taxpayer, had

no employees and was managed by Capstone. (App.Vol.4.p.1085, 1091; App.Vol.5.p.1320, 1424.)

#### a. Arrangements managed directly by Capstone

As discussed, taxpayer issued 35 direct-written policies to the affiliated insureds during the years at issue. Because the affiliated insureds had no history of the types of losses covered by their new policies (App.Vol.3.p.865, 892-93; App.Vol.4.p.906-07, 909; Br. 55), Capstone could not propose premiums based on historical loss data. Instead, it proposed premiums using guidelines prepared by a commercial underwriter (which were based on an insured's revenue or number of employees, regardless of industry) and its own judgment about whether those guidelines were appropriate for particular insureds. (App.Vol.5.p.1239-43.) Zumbaum approved the premiums proposed by Capstone based on his opinion that they were "affordable." (App.Vol.4.p.1127.)

During the years at issue, taxpayer paid only one claim under the 35 direct-written policies. As reflected in a "Notice of Claim" dated April 6, 2009, Peak informed taxpayer that its business had experienced a "[s]ignificant reduction of orders from Stillwater Mining Company."

(App.Vol.19.p.5407.) Peak sought coverage under its loss-of-major-customer policy (App.Vol.19.p.5407), which protected against "business interruption loss[es]" caused when a major customer reduced its services. (App.Vol.12.p.3302.)

On April 21, 2009, taxpayer issued a check to Peak for $150,000, drawn on taxpayer's account but signed by a Peak employee. (App.Vol.4.p.1123; App.Vol.12.p.3552.) On May 27, 2009, taxpayer issued another check for $14,820, again drawn on taxpayer's account but signed by a Peak employee. (App.Vol.12.p.3557.) On the same day, taxpayer and Peak executed a "Settlement and Release Agreement" providing that, in exchange for taxpayer's promise to pay $164,820 ($150,000 + $14,820), Peak "hereby completely releases and forever discharges [taxpayer] from any and all past or present claims, demands, obligations, causes of action, judgments, expenses and compensation of any nature whatsoever" arising from the April 2009 claim. (App.Vol.12.p.3553-55.)

Notwithstanding the foregoing release, taxpayer "[r]e-open[ed]" Peak's claim in August 2009 (App.Vol.19.p.5407) and, two weeks later, issued a third check for $175,000, yet again drawn on taxpayer's

account but signed by a Peak employee (App.Vol.12.p.3558). In January 2012, taxpayer and Peak executed a two-sentence addendum to the original Settlement and Release Agreement, providing that the April 2009 claim was now resolved in exchange for payments totaling $339,820 ($150,000 + $14,820 + $175,000). (App.Vol.12.p.3556.)

#### b. Arrangements managed by Capstone through PoolRe

At the same time that taxpayer issued the direct-written policies, taxpayer entered into two arrangements with PoolRe: (1) stop-loss endorsements to the direct-written policies, coupled with a quota share arrangement between PoolRe, taxpayer, and other Capstone-managed captives with which PoolRe had likewise issued stop-loss endorsements, and (2) a credit coinsurance arrangement. We describe each in turn.

1. Under the stop-loss endorsements, PoolRe agreed to pay a portion of covered losses under the direct-written policies in certain circumstances. In exchange, PoolRe became entitled to approximately 20 percent of the direct-written premiums that the affiliated insureds otherwise would have remitted to taxpayer: $76,236 in 2008, $82,903 in 2009, and $88,617 in 2010. (App.Vol.11.p.3108-09, 3285-86; App.Vol.12.p.3423-23.)

Under the 2008 and 2009 stop-loss endorsements, PoolRe became potentially obligated to pay the portion of covered losses under the corresponding direct-written policies that exceeded the premiums paid by the affiliated insureds for those policies, with an outer limit of liability equal to 150 percent of those premiums. (App.Vol.11.p.3270-77; App.Vol.12.p.3411-20.) Thus, under the 2009 endorsement, PoolRe became potentially obligated to pay the portion of covered losses under the 2009 direct-written policies in excess of $448,127, and its liability was capped at $672,190.50 (150 percent of $448,127). Before PoolRe could be liable, however, one of four "attachment points" had to occur, *i.e.*, the affiliated insureds had to incur a certain number of covered losses of a particular dollar amount, as follows: (i) two losses of at least $100,000 apiece, (ii) three losses of at least $60,000 apiece, (iii) four losses of at least $50,000 apiece, or (iv) five losses of at least $20,000 apiece. (App.Vol.11.p.3270-71; App.Vol.12.p.3411-12.) For example, the stop-loss coverage would not have been triggered if the affiliated insureds had experienced two losses of $950,000 and $75,000. (App.Vol.11.p.3273; App.Vol.12.p.3415.) The affiliated insureds did not

incur sufficient covered losses to trigger the stop-loss coverage in 2008 or 2009. (App.Vol.3.p.870; App.Vol.4.p.908.)

Under the 2010 stop-loss endorsement, PoolRe was obligated to pay 50 percent of the portion of covered losses under the direct-written policies that exceeded 35 percent of the premiums paid by the affiliated insureds for those policies, and its liability was capped at 100 percent of those premiums. (App.Vol.12.p.3545-47.) Thus, PoolRe was responsible for 50 percent of covered losses in excess of $155,859.90 (35 percent of $445,314), and its liability was capped at $445,314. Notwithstanding this lower threshold, the affiliated insureds did not incur sufficient covered losses to trigger the stop-loss coverage in 2010. (App.Vol.3.p.870; App.Vol.4.p.908.)

At the same time that it executed stop-loss endorsements to taxpayer's direct-written policies, PoolRe executed stop-loss endorsements to approximately 500 other direct-written policies that approximately 50 other Capstone-managed captives had issued to their own affiliates (about 150 insureds in the aggregate). (App.Vol.5.p.1416.) Like the affiliated insureds, these insureds had no

significant history of the types of losses covered by their new policies. (App.Vol.4.p.1192.)

Taxpayer and the other 50 Capstone-managed captive insurers entered into a quota share arrangement each year in which they collectively agreed to reinsure the pool of risks they had collectively ceded to PoolRe under the stop-loss endorsements. (App.Vol.11.p.3250-60; App.Vol.12.p.3389-3400, 3522-33.) In exchange, each captive (including taxpayer) was entitled to reinsurance premiums from PoolRe equal to the stop-loss premiums it had ceded to PoolRe, less its *pro rata* responsibility for any losses under the pool of stop-loss endorsements. (App.Vol.11.p.3258-60; App.Vol.12.p.3398-400, 3530-33.) Because none of the 150 insureds experienced sufficient losses to trigger the stop-loss coverage during the years at issue (App.Vol.4.p.1199; App.Vol.5.p.1256, 1490), each captive (including taxpayer) received back from PoolRe the exact amount it had ceded to PoolRe in stop-loss premiums. (App.Vol.9.p.2475, 2483, 2496.)

2. Taxpayer also claimed to be part of a credit coinsurance arrangement with PoolRe, under which PoolRe ceded to taxpayer the obligation to reinsure approximately one percent of a portion of risks

covered under insurance policies issued in connection with alleged vehicle service contracts. (App.Vol.11.p.3261, 3268; App.Vol.12.p.3401, 3408, 3534, 3541.) The coinsurance contracts indicated that the vehicle service contracts had originally been covered under a policy issued by a U.S. insurer, and that a portion of that coverage had been ceded to multiple foreign entities before reaching taxpayer. (App.Vol.11.p.3268; App.Vol.12.p.3408, 3541.) In its general ledgers, taxpayer recorded premiums earned under the coinsurance contracts that slightly exceeded claims paid. (App.Vol.9.p.2477-78 (in 2008, premiums of $69,500 and losses of $61,160), 2487, 2489-90 (in 2009, premiums of $76,500 and losses of $70,332), 2500-01, 2504 (in 2010, premiums of $66,000 and losses of $56,400).)

#### 4. IRS examination

In September 2010, taxpayer withdrew its application for recognition of tax-exempt status after the IRS requested additional information. (App.Vol.2.p.366.) Nonetheless, taxpayer continued to file tax returns claiming tax-exempt status. (App.Vol.6.p.1596-684.) The IRS examined taxpayer's returns for 2008, 2009, and 2010 and determined income tax deficiencies of $144,538, $164,418, and

$168,305, respectively. (App.Vol.1.p.15-21.) The deficiencies were based on the IRS's determination that taxpayer's arrangements did not constitute insurance and that taxpayer's "primary and predominant activity [was] not insurance." (App.Vol.1.p.18.) The IRS further determined that, because taxpayer was not an insurance company (tax-exempt or otherwise), its election to be taxed as a domestic corporation under I.R.C. § 953(d) was invalid. (App.Vol.1.p.18.) Consequently, the IRS determined that taxpayer – as a non-exempt foreign corporation – was subject to the 30-percent tax imposed by I.R.C. § 881(a) on certain fixed or determinable annual or periodic income ("FDAP income") from U.S. sources. (App.Vol.1.p.18.)

### D. Proceedings in the Tax Court

Taxpayer filed the instant suit in the Tax Court. Following trial, the court held that taxpayer was not an insurance company for federal tax purposes because its arrangements did not satisfy two of the four commonly cited criteria for insurance under the tax law: they did not achieve risk distribution, and they did not constitute insurance in the commonly accepted sense of the word. (App.Vol.3.p.882-900; App.Vol.4.p.900-11.)

First, the court rejected taxpayer's argument that it had achieved risk distribution through its participation in the quota share and credit coinsurance arrangements involving PoolRe. Regarding the former, the court determined that PoolRe's activities as they related to the quota share arrangement were not those of a *bona fide* insurance company, such that the arrangement was not *bona fide* reinsurance. Regarding the latter, the court determined that taxpayer had not established that the vehicle service contracts underlying the credit coinsurance arrangement actually existed and that, at all events, any risk distribution achieved would have been *de minimis*. (App.Vol.3.p.883-97.)

The court also rejected taxpayer's argument that its arrangements constituted insurance in the commonly accepted sense. In doing so, the court accorded significant weight to its findings that taxpayer was not operated as a *bona fide* insurance company, charged premiums that were not commercially reasonable, and did not engage in truly arm's-length transactions.[3] (App.Vol.3.p.897-900; App.Vol.4.p.901-11.)

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[3] Because the court determined that taxpayer was not an insurance company, it had no occasion to reach the Commissioner's

Turning to the correct treatment of funds received by taxpayer, the court explained that taxpayer had the burden of establishing that such amounts were something other than FDAP income, as determined by the IRS. Although taxpayer had reported the funds as income on its tax returns, it now argued that they should be recharacterized as nontaxable contributions to capital, advances, or deposits. Because taxpayer failed to identify any evidence that supported its proposed recharacterization, the court sustained the Commissioner's determination. (App.Vol.4.p.913-15.) Taxpayer filed a motion for partial reconsideration, which the court denied. (App.Vol.4.p.916-33, 949.)

The Commissioner conceded that premiums to which taxpayer was allegedly entitled under the credit coinsurance arrangement were not subject to the 30-percent tax on U.S.-source FDAP income received by a foreign corporation because there was no evidence that taxpayer actually received those amounts. (App.Vol.3.p.793.) Consistent with that concession, the court entered a decision that taxpayer had income

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alternative argument (App.Vol.2.p.502-19) that taxpayer's purported insurance and reinsurance arrangements lacked economic substance. (App.Vol.4.p.911 n.3.)

tax deficiencies of $123,688, $141,468, and $148,505 for 2008, 2009, and 2010, respectively. (App.Vol.4.p.1003.)

## SUMMARY OF ARGUMENT

1. This Court has made clear that, where a purported insurance arrangement has the effect of merely setting aside the insured's funds as a reserve against its own future losses, the arrangement does not constitute insurance for federal tax purposes. *Beech Aircraft Corp. v. United States*, 797 F.2d 920, 922 (10th Cir. 1986); *Stearns-Roger Corp. v. United States*, 774 F.2d 414, 415 (10th Cir. 1985). Such was the case here; taxpayer received funds from the affiliated insureds as part of a series of arrangements that neither distributed risk nor satisfied commonly accepted notions of insurance. The Tax Court's fact-bound determinations in that regard – each fatal to taxpayer's case – are firmly grounded in the record.

First, the court correctly determined that taxpayer did not achieve significant risk distribution through its participation in the quota share and credit coinsurance arrangements. Although taxpayer nominally participated in the reinsurance of a pool of unrelated risks pursuant to the quota share arrangement, the court correctly found that the

arrangement did not constitute *bona fide* reinsurance because the purported reinsured, PoolRe, was not a *bona fide* insurance company in the first place. Indeed, the entire arrangement was designed to ensure – and, as a factual matter, did ensure – that taxpayer and the other Capstone-managed participants were ultimately responsible for paying only their own affiliates' losses, thereby precluding any risk distribution. As to taxpayer's other purported risk-distribution vehicle, the credit coinsurance arrangement, the Tax Court correctly found that taxpayer failed to establish that it even existed. Either finding is sufficient on its own to preclude an adequate level of risk distribution; neither is clearly erroneous. *See Harper Group v. Commissioner*, 979 F.2d 1341, 1342 (9th Cir. 1992) (reviewing risk-distribution determination for clear error).

Second, the Tax Court correctly determined that taxpayer's arrangements did not constitute insurance in the commonly accepted sense, based on its findings that (a) neither taxpayer nor anyone with a financial interest therein conducted management, oversight, or due diligence, (b) taxpayer issued cookie cutter policies to the affiliated insureds that increased their insurance expenses by approximately

400 percent without satisfying a genuine need for coverage, (c) the premiums charged were neither reasonable in relation to the risk of loss nor negotiated at arms'-length, and (d) the single claim that taxpayer paid was handled in an unusual and irregular manner. These findings likewise were not clearly erroneous.

2. Because its arrangements did not constitute insurance, taxpayer was not an insurance company exempt from tax under I.R.C. § 501(c)(15). As a non-exempt foreign corporation with qualifying income from a U.S. source, taxpayer was therefore subject to the 30-percent tax imposed by I.R.C. § 881(a).

On its tax returns for 2008, 2009, and 2010, taxpayer reported the funds at issue as income. Once in court, however, taxpayer sought to recharacterize those amounts as capital contributions. In determining whether a payment to a corporation constitutes a nontaxable contribution to capital, the controlling inquiry is the transferor's intent. *United States v. Chicago, Burlington & Quincy R.R.*, 412 U.S. 401, 411-12 (1973); *Hayutin v. Commissioner*, 508 F.2d 462, 480 (10th Cir. 1974). The Tax Court correctly declined to recharacterize the payments to taxpayer as capital contributions, given taxpayer's failure to identify

any evidence that the common owners of the transferor and transferee entities had so intended them. Taxpayer's argument to the contrary – in essence, that the Tax Court's analysis of the insurance issue mandates a finding that the payments were capital contributions – is wholly lacking in merit.

The decision of the Tax Court is correct and should be affirmed.

## ARGUMENT

## I.

### The Tax Court correctly determined that taxpayer was not an insurance company for federal tax purposes during the years at issue

#### Standard of review

This Court reviews the Tax Court's factual findings for clear error and its legal conclusions *de novo*. *Anderson v. Commissioner*, 62 F.3d 1266, 1270 (10th Cir. 1995). Where an issue involves a mixed question of fact and law, this Court reviews the Tax Court's resolution thereof either for clear error or *de novo*, depending on whether the question is primarily factual or legal. *Id.* Although we submit that the insurance issue is a mixed question of fact and law that is primarily

factual,[4] we further submit that the Tax Court's resolution of that issue may be affirmed under either standard of review.

### A. Introduction

Sections 501(a) and (c)(15) of the I.R.C. provide that non-life, non-mutual insurance companies are exempt from income tax if (i) their gross receipts for the year do not exceed $600,000 and (ii) more than 50 percent of such receipts consist of insurance premiums.
Section 501(c)(15) incorporates the definition of "insurance company" contained in Section 816(a), namely "any company more than half of the business of which during the taxable year is the issuing of insurance or annuity contracts or the reinsuring of risks underwritten by insurance companies." I.R.C. § 816(a). Although the Code does not define "insurance" (*Stearns-Roger*, 774 F.2d at 415), courts have held that an

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[4] As taxpayer notes (Br. 30), in *AMERCO, Inc. v. Commissioner*, 979 F.2d 162, 164 (9th Cir. 1992), the court stated that "[w]hether the transactions [at issue there] constitute insurance is a question of law subject to de novo review." But the *AMERCO* court itself recognized that the case it cited for that proposition had been decided by the Tax Court on stipulated facts. *Id.* (citing *Clougherty Packing Co. v. Commissioner*, 811 F.2d 1297, 1299 (9th Cir. 1987)). Indeed, the *AMERCO* court couched its own risk-distribution analysis in terms of clear-error review. 979 F.2d at 168; *see also Harper*, 979 F.2d at 1342 (same).

arrangement does not constitute insurance for federal tax purposes unless it (1) involves insurable risk, (2) shifts risk from the insureds to the insurer, (3) distributes risk, and (4) constitutes insurance in the commonly accepted sense. *Helvering v. Le Gierse*, 312 U.S. 531, 539-40 (1941); *AMERCO*, 979 F.2d at 165; *Black Hills Corp. v. Commissioner*, 101 T.C. 173, 182 (1993), *aff'd*, 73 F.3d 799 (8th Cir. 1996); *Rent-A-Center, Inc. v. Commissioner*, 142 T.C. 1, 13 (2014).

As discussed below, the Tax Court correctly determined, and certainly did not clearly err in finding, that taxpayer's arrangements did not satisfy either the third criteria (risk distribution) or fourth criteria (insurance in the commonly accepted sense) listed above. Each of these determinations is, by itself, sufficient to demonstrate that the arrangements did not constitute insurance for tax purposes. As a necessary corollary, less than 50 percent of taxpayer's gross receipts consisted of insurance premiums and less than half its business involved the issuance of insurance contracts or reinsurance. Taxpayer was not, therefore, an insurance company during the years at issue within the meaning of I.R.C. § 501(c)(15).

### B. Taxpayer's arrangements did not distribute risk

#### 1. Risk distribution in general and in the context of captives

As defined by this Court, risk distribution "means that the party assuming the risk distributes his potential liability, in part, among others." *Beech Aircraft*, 797 F.2d at 922. Risk distribution occurs when the premiums of numerous insureds are pooled together, so that no single insured is, in significant part, paying for its own risks. *Id.*; *Clougherty Packing*, 811 F.2d at 1300; *Commissioner v. Treganowan*, 183 F.2d 288, 291 (2d Cir. 1950). Through the "law of large numbers," risk distribution has the effect, over time, of "smooth[ing] out losses to match more closely [the insurer's] receipt of premiums." *Clougherty Packing*, 811 F.2d at 1300.

Risk distribution is distinct from risk shifting, which "means one party shifts his risk of loss to another." *Beech Aircraft*, 797 F.2d at 922. However, the two concepts are often analyzed together in the captive context: "in most instances the facts which demonstrate[ ] that one did not exist also demonstrate[ ] that the other did not." *AMERCO*, 979 F.2d at 165. For example, where "[a]s a matter of economic reality every dollar paid out by the captive [to the parent] was a dollar out of

the parent's pocket from whence it came in the first place," the arrangement has neither shifted nor distributed risk. *Id.* at 166; *cf. Beech Aircraft*, 797 F.2d at 922-23.

So viewed, captive arrangements are inherently suspect if they involve only the risks of a small number of affiliated parties. *See Stearns-Roger*, 774 F.2d at 415 (disallowing deductions for premiums paid to captive by parent and its subsidiaries, affiliates, and associates); *Ocean Drilling & Exploration Co. v. United States*, 988 F.2d 1135, 1150 (Fed. Cir. 1993). Captive arrangements can nonetheless achieve risk distribution "where a substantial part of the insurer's business" comes from unrelated sources. *AMERCO*, 979 F.2d at 168. A *de minimis* amount, however, is insufficient. *Beech Aircraft*, 797 F.2d at 922; *Harper*, 979 F.2d at 1342; *Gulf Oil Corp. v. Commissioner*, 914 F.2d 396, 411-12 (3d Cir. 1990).

Where, as here, an insurer seeks to achieve risk distribution based on the percentage of premiums that it receives from a pool of unrelated insureds,[5] the IRS has ruled that 50 percent is sufficient (as long as the

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[5] There are situations where the number of affiliated insureds and the breadth of their risks covered by the captive insurer may be

pool contains a sufficient number of unrelated risks). Rev. Rul. 2002-89 at *1; *see also AMERCO*, 979 F.2d at 164, 168 (52 to 74 percent was sufficient). In two cases, courts have found that risk distribution was achieved where less than 50 percent of the captive's premiums derived from unrelated insureds (and the pool contained a sufficient number of unrelated risks). *Ocean Drilling*, 988 F.2d at 1153 (44 to 66 percent); *Harper*, 979 F.2d at 1342 (approximately 30 percent). Capstone's owner, Stewart Feldman, represented that the 30-percent figure from *Harper* – the lowest judicially approved risk-distribution percentage of which the Commissioner is aware – was "commonly accepted in the insurance industry." (App.Vol.5.p.1417; *see also* Rev. Rul. 2002-89, 2002-2 C.B. 984, at *1 (10 percent is insufficient).) Taxpayer does not argue that a captive could achieve risk distribution on the basis of unrelated business if materially less than 30 percent of its premiums derived from unrelated insureds.

Here, approximately 70 percent of taxpayer's premiums derived from the direct-written policies it issued to the affiliated insureds,

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sufficient by themselves to achieve risk distribution. *See, e.g.*, *Securitas Holdings, Inc. v. Commissioner*, T.C. Memo. 2014-225 (unpublished); *Rent-A-Center, supra*. That is not the case here.

approximately 15 percent derived from the quota share arrangement, and approximately 15 percent derived from the credit coinsurance arrangement. *Supra*, pp. 7-8, 11-15. The Tax Court concluded, and taxpayer does not dispute, that premiums from the direct-written policies were immaterial to the risk-distribution inquiry. (App.Vol.3.p.884-85.) Accordingly, taxpayer cannot satisfy its own test – *i.e.*, "the 30% threshold recognized . . . in *Harper*" (Br. 24) – unless it establishes that both the quota share arrangement and credit coinsurance arrangement were effective risk-distribution vehicles. Neither fits the bill.

### 2. Taxpayer did not achieve risk distribution through the quota share arrangement

#### a. Because PoolRe was not a *bona fide* insurance company, the quota share arrangement was not *bona fide* reinsurance

The Tax Court began its analysis by noting 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.) Following the approach it had adopted in *Avrahami v. Commissioner*, 149 T.C. 144,

185 (2017), the court reasoned that the quota share arrangement could not be an insurance transaction unless PoolRe itself was a *bona fide* insurance company. (App.Vol.3.p.887.) The court then listed (App.Vol.3.p.887-88) the nine factors the *Avrahami* court had culled from the court's decision in *Rent-A-Center*, 142 T.C. at 10-13, as bearing on the determination whether an entity is a *bona fide* insurance company: (1) whether the entity was created for legitimate nontax reasons, (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 the entity was subject to regulatory control and met minimum statutory requirements, (8) whether the entity was adequately capitalized, and (9) whether the entity paid claims from a separately maintained account. *See Avrahami*, 149 T.C. at 185; *see also Syzygy Ins. Co., Inc. v. Commissioner*, T.C. Memo. 2019-34, at 29-30 (unpublished). Weighing the six factors that it found most probative, the Tax Court determined

that, as it related to the quota share arrangement, PoolRe was not a *bona fide* insurance company. (App.Vol.3.p.887-95.)

Circular flow of funds: The court first found that the quota share arrangement "'look[ed] suspiciously like a circular flow of funds'" from PoolRe's perspective. (App.Vol.3.p.890 (quoting *Avrahami*, 149 T.C. at 186).) In 2008, 2009, and 2010, PoolRe received premiums under the stop-loss endorsements to taxpayer's direct-written policies amounting to $76,236, $82,903, and $88,617, respectively. (App.Vol.11.3108-09, 3285-86; App.Vol.12.p.3423-23.) PoolRe paid reinsurance premiums to taxpayer under the quota share arrangements for those years in the same amounts: $76,236, $82,903, and $88,617, respectively. (App.Vol.9.p.2475, 2483, 2496.) That equivalence reflects the fact that taxpayer "never . . . had any losses or expenses in connection with its purported quota share liabilities." (App.Vol.3.p.890.) It follows that there were no stop-loss claims against PoolRe under any direct-written policy issued by the captives participating in each year's quota share arrangement, since taxpayer would have been responsible for – *i.e.*, the reinsurance premium it ultimately stood to receive from PoolRe would have been reduced by – its *pro rata* share of any such claim. (*See, e.g.*,

App.Vol.11.p.3255-56.) Each of those other captives, then, likewise received the same amounts from PoolRe under each year's quota share arrangement that it had ceded to PoolRe pursuant to stop-loss endorsements. In other words, the circular flow of funds extended far beyond PoolRe's dealings with taxpayer.

Arm's-length contracts: As the Tax Court aptly observed, the "perfect matching of payments" described above also supports the conclusion that the arrangements between PoolRe and the Capstone-managed captives were "not the product of arm's length considerations." (App.Vol.3.p.890.) In particular, the court found that taxpayer had failed to explain "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)" to PoolRe under stop-loss endorsements while assuming from PoolRe "a blended portion of completely different risks" pursuant to the quota share arrangements "for exactly the same premium price." (App.Vol.3.p.891.)

On appeal, taxpayer claims that the stop-loss premiums charged by PoolRe and the quota-share (reinsurance) premiums paid by PoolRe were calculated using "actuarial methods" and "objective criteria," but

still fails to explain why they were the same amounts.[6] (*See* Br. 22.) Instead, it baldly asserts that PoolRe's agreements with the Capstone-managed captives "were inherently arm's-length agreements because the contracting parties were unrelated." (Br. 44.) It is true that PoolRe and the Capstone-managed captives (including taxpayer) were distinct entities with distinct owners. However, like the captives, PoolRe delegated its administration, operations, and recordkeeping to Capstone. (App.Vol.3.p.871; App.Vol.4.p.1085, 1091; App.Vol.5.p.1320, 1424; App.Vol.6.p.1596, 1615, 1653.) PoolRe and the captives were thus effectively under common control, and their relationship cannot fairly be characterized as arm's-length. Tellingly, taxpayer's expert, Neil Doherty, testified that he had never seen another arrangement in which a single entity managed both a captive and the reinsurer through which the captive ostensibly participated in a risk pool, nor had he seen an arrangement where all of the captives participating in such a pool were managed by the same entity. (App.Vol.4.p.1198-99.)

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[6] Taxpayer also asserts (Br. 21-22) that "the Commissioner has issued numerous private letter rulings approving of similar [quota share] arrangements" involving offsetting premiums. But the rulings taxpayer cites do not focus on the operations of the entity through which the captives participated in the risk-sharing pool (here, PoolRe).

Without citation to the record, amici urge that the reinsurance premiums received by the captives from PoolRe were necessarily equal to the stop-loss premiums ceded by the captives to PoolRe because the risks assumed by the captives from PoolRe under the quota share arrangement "equaled" the risks ceded by the captives to PoolRe under the stop-loss endorsements. (Amicus 15-16, 23-28.) However, another explanation is that the PoolRe risk pool was "simply . . . a risk-free account through which premiums temporarily stopover on their way to the individual client's captive." Jay Adkisson, *Analysis of the IRS's Big Win against Risk-Pooled Small Captives in Reserve Mechanical*, https://www.forbes.com/sites/jayadkisson/2018/06/25/ analysis-of-the-irss-big-win-against-risk-pooled-small-captives-in-reserve-mechanical/#1488516f5de9 (June 25, 2018). The latter explanation, adopted by the court, is far more compelling in light of the complete absence of any claims under the stop-loss endorsements (and therefore under the quota sharing arrangements). *See supra*, pp. 30-31.

Actuarially determined premiums: Turning to whether the premiums that PoolRe charged under the stop-loss endorsements involving taxpayer and the other Capstone-managed captives were

actuarially determined, the court observed not only that the premiums were based on "a flat percentage of the gross direct written premiums" charged by the captives, but also that every captive ceded the *same* percentage to PoolRe. (App.Vol.3.p.891-92.) Yet taxpayer submitted no evidence regarding the other 50 captives participating in the quota share arrangements or their insureds, such as the underlying "industries and the risks involved and the specific amounts of exposure." (App.Vol.3.p.891-92.) The court therefore found that the stop-loss premiums represented a troublesome "one-size-fits-all" approach. (App.Vol.3.p.892.) As one commentator put it, "if the risk pool [*i.e.*, PoolRe] were really acting in its own economic self-interest in pricing policies, it wouldn't price policies on a flat-fee basis (no real insurance company does that), but instead would price premiums based on the risk that it incurr[ed] and on the amount of profit that it could extract from insureds." *Analysis of the IRS's Big Win*, *supra*.

Actual and insurable risk: The court had ample grounds to find that "PoolRe was removed far from any actual risk associated with the business or operations of [taxpayer]'s insureds." (App.Vol.3.p.893.) First, PoolRe provided stop-loss coverage for supplemental policies that

provided excess coverage themselves, *i.e.*, the direct-written policies provided coverage only after the affiliated insureds had exhausted coverage under "any other valid and collectible insurance policy." (*E.g.*, App.Vol.11.p.3113 (capitalization omitted); App.Vol.3.p.863.) For example, as acknowledged in the feasibility study (App.Vol.7.p.2054), Peak had some protection against pollution claims under its commercial policies (App.Vol.10.p.2808-09, 2852, 2916). Thus, if Peak had experienced a pollution-related loss covered by its commercial policies, its commercial insurer would have had primary responsibility for paying the claim; taxpayer would have had secondary responsibility under the applicable direct-written policy, and PoolRe would have had only tertiary responsibility under the corresponding stop-loss endorsement.

Taxpayer strenuously objects to the court's characterization of its direct-written policies as providing "excess coverage," asserting (Br. 51) that "[n]one of Peak's commercial insurance policies covered the same risk of loss as [taxpayer's] direct-written policies did." But the expert report taxpayer cites in support of that proposition makes no such

blanket assertion.[7] And while there may have been many instances in which the excess coverage would have "'drop[ped] down'" (Br. 50) and provided primary coverage, the point remains that the excess-coverage clauses provided an additional potential barrier between the underlying risks and PoolRe.

Second, the stop-loss endorsements that PoolRe executed were drafted so that, even if an insured were to experience a covered loss under the corresponding direct-written policy, the insured's captive would almost certainly remain fully responsible for the loss. In 2008 and 2009, PoolRe's obligation under the stop-loss endorsements to taxpayer's direct-written policies was not triggered unless the affiliated insureds experienced multiple covered losses of a high dollar amount. *Supra*, pp. 12-13. For instance, even if the affiliated insureds had incurred a covered loss during 2009 in excess of the threshold amount

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[7] The report does state that "pollution liability . . . [was] excluded from all underlying policies" (App.Vol.12.p.3576), but that paragraph is lifted verbatim from the *post hoc* feasibility study (App.Vol.7.p.2049), which itself was essentially attorney work-product to be brandished when the IRS came calling. And the report omits the contradictory statement in the feasibility study acknowledging that Peak did have "limited [pollution liability] coverage provided as part of its commercial general liability and products liability policies." (App.Vol.7.p.2054.)

under that year's stop-loss endorsement ($448,127), PoolRe would have had no obligation thereunder if the affiliated insureds had incurred no other covered losses during the year. (App.Vol.11.p.3270-71; App.Vol.12.p.3411-12; *see* App.Vol.3.p.872-73.) And the terms of the stop-loss endorsements that PoolRe executed with the other Capstone-managed captives were similarly restrictive.[8] (App.Vol.2.p.574; App.Vol.3.p.873.)

Licensed and regulated as an insurance company: Under Anguillan law, PoolRe was required to obtain an insurance license before issuing policies. (App.Vol.7.p.1984.) However, it did not obtain a license until April 2009 – after it had already executed stop-loss endorsements for two of the three years at issue. (App.Vol.11.p.3281.)

Created for legitimate nontax reasons: Although taxpayer contends that PoolRe was formed to enable the Capstone-managed captives (including taxpayer) to distribute among themselves (through the quota share arrangement) the related-party risks each had

[8] Although the 2010 stop-loss endorsements featured lower coverage thresholds, the result was the same: no claims under any of the stop-loss endorsements executed by PoolRe with the 50-odd Capstone-managed captives (including taxpayer). (App.Vol.4.p.1199; App.Vol.5.p.1256, 1490.)

separately insured, the net economic result of the arrangement was no different than if each group of related-party insureds had simply paid its stop-loss premiums directly to its affiliated captive insurer. That result supports the Tax Court's finding that the quota share arrangements, as implemented through PoolRe, were not intended to – and did not – distribute risk. And taxpayer has not argued that PoolRe served any other purpose. Accordingly, the court correctly found that, from the perspective of Zumbaum and Weikel (who owned both Peak and taxpayer), "[t]he only purpose PoolRe served through the quota share arrangement was to shift income from Peak to [taxpayer]" on a tax-free basis. (App.Vol.3.p.894.)

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Based on the foregoing, the Tax Court correctly held that PoolRe was not a *bona fide* insurance company, and that the quota share arrangements therefore did not constitute *bona fide* reinsurance and could not have achieved risk distribution for taxpayer.[9] The opinion of

[9] Taxpayer asserts (Br. 18-19) that "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." But the accompanying record cite is to a series of IRS determination letters

taxpayer's expert, Neil Doherty, to the contrary (Br. 24-25) not only turns a blind eye to substance, but also is unconvincing on its own terms. Doherty reviewed the quota share arrangement "in general," based on a memorandum authored by Feldman, and opined that, "[o]n its face," the arrangement achieved "at least as much risk distribution" as in *Harper*, *supra*. (App.Vol.4.p.1190, 1198-99; App.Vol.13.p.3702, 3714, 3738-44.) But Doherty did not review the individual risks of the 150 insureds that participated in the quota share arrangement and, therefore, did not consider the likelihood that the participating captives would ever be required to pay a claim or otherwise function as reinsurers of PoolRe's putative stop-loss obligations. (App.Vol.4.p.1198.)

#### b. Taxpayer's critique of the Tax Court's focus on PoolRe's *bona fides* is unavailing

Despite lodging its disagreement with some of the Tax Court's factual findings, taxpayer's opening brief fails to challenge the court's determination that, as it related to the quota share arrangement, PoolRe was not a *bona fide* insurance company. This Court should

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conditionally recognizing the exempt status of various applicants under § 501(c)(15); the letters reveal nothing about PoolRe's risk pool.

therefore treat the issue as waived. *Reedy v. Werholtz*, 660 F.3d 1270, 1274 (10th Cir. 2011).

Taxpayer instead contends that this line of inquiry is irrelevant. (Br. 38-41.) To be sure, taxpayer is correct that an insurer can achieve risk distribution through a risk pool that does not meet the I.R.C.'s formal definition of an insurance company. *Ross v. Odom*, 401 F.2d 464, 465-70 (5th Cir. 1968); *Treganowan*, 183 F.2d at 290-91. However, the Tax Court did not invalidate the quota share arrangement on the ground that PoolRe failed to meet the formal definition of an insurance company. Rather, it invalidated the quota share arrangement on the ground that, as a matter of substance, PoolRe did not perform the *functions* of an insurance company – regardless of label – *vis-à-vis* the quota share arrangement. *See also Bowers v. Lawyers' Mortg. Co.*, 285 U.S. 182, 188 (1932) ("the character of the business actually done . . . determines whether [the entity] was taxable as an insurance company"); Rev. Rul. 83-172, 1983-2 C.B. 107, at *2.

Taxpayer's argument that the Tax Court's approach would undo the result in cases like *Ross* and *Treganowan* if the *de facto* insurer had taken the additional step of reinsuring its risks through one or more

unrelated captives seeking to achieve risk distribution (Br. 41-42) therefore misses the mark. Again, the relevant inquiry is whether the entity that the captives reinsure performs the substantive functions of an insurance company, not whether it is licensed and regulated as an insurance company. Indeed, that formality is but one of the nine factors listed by the Tax Court as relevant to the *bona-fide*-insurance-company inquiry. Thus, nothing in the Tax Court's analysis undermines cases like *Ross* and *Treganowan*.

Finally, taxpayer complains that, at the time of trial, it failed to appreciate the importance of demonstrating that PoolRe was a *bona fide* insurance company. (Br. 45 n.7.) However, taxpayer raises this complaint in a footnote, without identifying any specific evidence it would have offered to address this issue. (*Id.*) This Court should therefore treat the issue as waived. *United States v. Hardman*, 297 F.3d 1116, 1131 (10th Cir. 2002) (en banc). Moreover, taxpayer offers no convincing explanation why it failed to realize the importance of demonstrating that the entity through which it participated in the quota share arrangement was itself a *bona fide* insurance company. In any event, taxpayer could have moved to reopen the record to offer

additional evidence when the Tax Court requested supplemental briefing regarding *Avrahami*. (App.Vol.3.p.797; *Butler v. Commissioner*, 114 T.C. 276, 286-87 (2000), *abrogated on other grounds by Porter v. Commissioner*, 132 T.C. 203 (2009).) Having chosen not to do so, taxpayer is poorly positioned to complain.

**3. Taxpayer did not achieve risk distribution through the credit coinsurance arrangement**

As the Tax Court noted, the quota share arrangement's illegitimacy made the legitimacy of the credit coinsurance arrangement largely academic. (App.Vol.3.p.896.) Nonetheless, the court found that taxpayer had failed to establish that a real credit coinsurance arrangement existed. (App.Vol.4.p.895-96.) This finding provides an additional basis to affirm the court's determination that taxpayer did not achieve risk distribution.

According to the coinsurance contracts, PoolRe ceded to taxpayer the obligation to reinsure approximately one percent of a portion of risks covered under insurance policies issued in connection with vehicle service contracts. (App.Vol.11.p.3261, 3268; App.Vol.12.p.3401, 3408, 3534, 3541.) The coinsurance contracts indicate that the vehicle service contracts were originally insured under a policy issued by a U.S.

insurer, Lyndon Property Insurance Company. (App.Vol.11.p.3268; App.Vol.12.p.3408, 3541.) They further indicate that Lyndon had ceded some portion of its insurance obligations to a Bermudan insurer, Aria (SAC) Ltd., which then ceded some portion to a Nevis-Island-based insurer, Credit Reassurance Corporation, Ltd. ("CreditRe"), which in turn ceded some portion to Anguilla-based PoolRe. (App.Vol.11.p.3268; App.Vol.12.p.3408, 3541.)

An attorney representing PoolRe's owner stated that taxpayer had copies of all documents maintained by PoolRe concerning transactions in which taxpayer participated. (App.Vol.4.p.1020-21.) Taxpayer also had the contractual right to obtain all coinsurance documents maintained by PoolRe. (App.Vol.11.p.3264; App.Vol.12.p.3404, 3537.) Taxpayer failed, however, to submit into evidence the underlying vehicle service contracts; the insurance agreement between the service providers and Lyndon; or the contracts that ceded obligations from Lyndon to Aria, Aria to CreditRe, and CreditRe to PoolRe. Instead, it

attempted to fill these documentary gaps through the testimony of CreditRe's owner, Gary Fagg, and Feldman.[10]

Taxpayer did submit its general ledgers into evidence. According to the ledgers, taxpayer earned premiums under the coinsurance contracts that slightly exceeded the claims paid under the contracts, meaning that it would have been entitled to nominal payments from PoolRe each year. *Supra*, p. 15. Taxpayer did not, however, submit into evidence any claims documents, invoices, or similar records to establish that covered losses actually occurred. Nor did taxpayer submit into evidence any checks, wire transfers, or bank statements to establish that it actually paid any claims. Instead, it attempted to fill these documentary gaps through the testimony of Fagg and Feldman.

On this record, the Tax Court justifiably found that taxpayer had failed to prove "that the vehicle service contracts, which formed the basis for the reinsurance that PoolRe re-ceded in the coinsurance contracts, actually existed." (App.Vol.3.p.895-96.) The court therefore found that taxpayer had failed to prove that the coinsurance contracts

[10] CreditRe itself had no knowledge of taxpayer's formation or operations. (App.Vol.3.p.875.)

were *bona fide* reinsurance agreements that involved, much less distributed, actual risk. (App.Vol.4.p.895-96.) These findings are not clearly erroneous.

On appeal, taxpayer argues that, because the coinsurance policies were "treaty" reinsurance (rather than "facultative" reinsurance), it was not obligated to (a) evaluate the risks associated with the "thousands of vehicle service contracts reinsured under the coinsurance arrangements" or (b) process claims made thereunder. (Br. 44-45.) This is entirely beside the point. Taxpayer was obligated to prove that the coinsurance arrangements distributed risk, which it could only do by first establishing the existence of the vehicle service contracts, ceding agreements, and claims paid. It failed to do so.

### C. Taxpayer's arrangements did not constitute insurance in the commonly accepted sense

As we have just shown, the Tax Court did not clearly err in finding that taxpayer's arrangements with the affiliated insureds failed to achieve risk distribution. That finding provides a sufficient basis to affirm the Tax Court's determination that those arrangements did not constitute insurance for tax purposes and that taxpayer therefore was not an insurance company within the meaning of I.R.C. § 501(c)(15). As

an alternative ground for affirmance, the Tax Court did not clearly err in finding that taxpayer's arrangements were not insurance in the commonly accepted sense of that term.

The Supreme Court concluded long ago that Congress used the term "insurance" in the Internal Revenue Code in its commonly accepted sense. *Le Gierse*, 312 U.S. at 540. To determine whether arrangements constitute insurance in the commonly accepted sense, courts consider a number of factors, including the following: (1) whether the entity was organized, operated, and regulated as an insurance company, (2) whether the entity was adequately capitalized, (3) whether the policies were valid and binding, (4) whether the premiums were reasonable and the result of an arm's-length transaction, and (5) whether claims were paid. *See Harper*, 96 T.C. 45, 60 (1991), *aff'd*, 979 F.2d 1341; *Humana Inc. v. Commissioner*, 881 F.2d 247, 253 (6th Cir. 1989); *Avrahami*, 149 T.C. at 191; *R.V.I. Guar. Co., Ltd. v. Commissioner*, 145 T.C. 209, 213 (2015). The Tax Court correctly determined that the balance of these factors demonstrated that taxpayer's arrangements did not constitute insurance, as that term is commonly understood.

#### 1. Organized, operated, and regulated as an insurance company

Although the Tax Court recognized that taxpayer generally complied with the requirements of Anguillan insurance law, it appropriately looked past these "formalities" in determining that taxpayer did not operate as an insurance company would normally operate. (App.Vol.3.p.899.)

a. Taxpayer's owners neither conducted nor oversaw its operations. Its co-owner, president, and chief executive officer (Zumbaum) "knew virtually nothing about [taxpayer's] operations." (App.Vol.3.p.899.) For example, Zumbaum lacked knowledge about taxpayer's direct-written policies, calculation of premiums, processes for handling claims, and types and location of records. (App.Vol.3.p.899; App.Vol.4.p.1127, 1132-35.) Nor did Zumbaum hire a single employee to conduct or oversee taxpayer's operations. (App.Vol.6.p.1596, 1615, 1653.) Instead, taxpayer's "planning, incorporation, and operations during the tax years in issue were managed entirely by Capstone." (App.Vol.3.p.899.)

On brief, taxpayer argues that it is "routine[ ]" and "reasonable" for captive owners to outsource all operations and oversight to an

outside manager (although it makes no similar defense of its chief executive officer's complete ignorance of the company's operations). (Br. 58-59.) This represents a striking departure from the feasibility study, which represented that "[c]aptive owners usually have complete control over the operations of their captives" (App.Vol.7.p.2042) and warned that an outside manager was no substitute for the "critical" oversight provided by ownership (App.Vol.7.p.2040).

Here, taxpayer's owners conducted no oversight or due diligence regarding any of its insurance arrangements. The Tax Court found no evidence of any due diligence relating to the direct-written policies apart from the feasibility study that Capstone produced, which was completed after taxpayer had already issued direct-written policies for two of the three years at issue. (App.Vol.3.p.899-900.) Moreover, of the three affiliated insureds covered by those policies, the feasibility study only provided details about Peak (App.Vol.7.p.2027-81) and included a solitary document concerning RocQuest and ZW (App.Vol.9.p.2648-55). Even for Peak, the study did not analyze the likelihood that it would experience a covered loss. *Supra*, p. 8; *infra*, pp. 56-57. Indeed, so little attention was paid to analyzing Peak's individual needs that, in two

instances, the study erroneously referred to it as "Alloy." (App.Vol.7.p.2069.)

The Tax Court also found that there was "no evidence that [taxpayer] performed any due diligence with respect to the reinsurance agreements that it executed with PoolRe." (App.Vol.3.p.900.) Nor did taxpayer "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 risk was distributed." (App.Vol.3.p.900; App.Vol.4.p.901.) The fact that taxpayer – without conducting even the most basic due diligence on its own behalf – was willing to assume the risks purportedly associated with the quota sharing arrangement suggests that its owners already knew what was later borne out in reality: taxpayer would ultimately be responsible for paying only the affiliated insureds' losses. *Supra*, pp. 30-31.

On appeal, taxpayer argues – to no avail – that the Tax Court's focus on the lack of due diligence with respect to the quota share and credit coinsurance arrangements ignores the distinction between

"treaty reinsurance" and "facultative reinsurance."[11] (Br. 44-45.) It is true that, once an entity enters into a treaty reinsurance contract, the reinsurer is obligated to assume a portion of all the risks underwritten; unlike in facultative reinsurance contracts, it does not have the right to assume some risks and reject others. *Delta Holdings, Inc. v. National Distillers and Chem. Corp.*, 945 F.2d 1226, 1229 (2d Cir. 1991). However, the Tax Court did not, as taxpayer suggests (Br. 44-45), take issue with taxpayer's failure to scrutinize the reinsurance arrangements on an ongoing basis. Rather, the court faulted taxpayer for failing to conduct due diligence *prior to entering into the arrangements*. (App.Vol.3.p.900; App.Vol.4.p.901-02.) For example, the credit coinsurance arrangement purported to reinsure risks originating from policies underwritten in January 2006. (App.Vol.11.p.3268; App.Vol.12.p.3408, 3541.) But taxpayer apparently never bothered to

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[11] Although the Commissioner's post-trial brief expressly refers to the lack of due diligence with respect to the reinsurance arrangements (App.Vol.2.p.483, 486, 525), taxpayer failed to draw any distinction between "treaty reinsurance" and "facultative reinsurance" in its 74-page reply (App.Vol.3.p.601-720) and only addressed the distinction in a footnote to a supplemental brief (App.Vol.3.p.821). This Court should therefore treat the argument as waived. *See, e.g., Little v. The Budd Company, Inc.*, 955 F.3d 816, 821 (10th Cir. 2020).

ascertain those policies' loss histories before agreeing to reinsure them. This supports the conclusion that taxpayer was not operating as a real insurance company. *See* Jay Adkisson, *Observations on Captive Insurance Companies: 10 Worst and 10 Best Things*, https://www.americanbar.org/groups/business_law/publications/blt/2014/02/04_adkisson/ (Feb. 22, 2014) (discussing reinsurance arrangements in which participants get a "wink-wink, nod-nod" assurance that "'actually you'll never lose anything significant'").

b. Apart from issuing insurance policies, an insurance company's defining activities are the processing and payment of claims. The Tax Court found that taxpayer handled the single claim it paid during the years at issue – approximately $340,000 to Peak under the loss-of-major-customer policy, after Stillwater Mining Company purportedly reduced its orders – in an "unusual" and irregular" manner. (App.Vol.4.p.902, 910.) If anything, that finding understates the unorthodox way in which the claim was processed. Taxpayer issued a check to Peak prior to securing a release, issued a second check at the same time that it secured a release, and subsequently reopened the claim to issue a third check. Taxpayer then waited nearly two-and-a-

half years before securing an addendum to the release. In addition, all three checks were signed by an employee of Peak, not taxpayer or its manager. *Supra*, pp. 10-11.

Moreover, taxpayer submitted no evidence that anyone investigated the merits of the claim (App.Vol.4.p.901), such as verifying that Stillwater "represent[ed] 10% or more of" Peak's annual sales, as required to constitute a "Major Customer" under the policy (App.Vol.11.p.3299); verifying the amount of lost revenue claimed by Peak (App.Vol.12.p.3303); verifying that the loss was not covered under one of Peak's commercial policies (App.Vol.11.p.3300); and verifying that the loss did not fall under one of four listed exclusions from coverage (App.Vol.12.p.3302).

In light of the foregoing, the Tax Court was entirely justified in finding that, although "Capstone . . . directed a series of transactions between its managed entities so that [taxpayer] appeared to be engaged in the business of issuing insurance contracts," taxpayer was not "operated as an insurance company in the commonly accepted sense." (App.Vol.4.p.902.)

### 2. Adequate capitalization

The Tax Court recognized that under its caselaw, a captive insurer that meets the statutory capitalization requirements of its domicile is considered adequately capitalized. (App.Vol.4.p.902.) Anguillan law required a minimum capitalization of $100,000 (App.Vol.7.p.1985), which taxpayer satisfied by virtue of having received an initial capital contribution in that amount (App.Vol.6.p.1596). *But see Avrahami*, 149 T.C. at 190 (acknowledging that the captive at issue there – domiciled in Nevis – "met that loosely regulated regime's low capitalization requirements," but observing that "that is not enough").

### 3. Valid and binding policies

The Tax Court acknowledged that taxpayer's direct-written policies "contained the necessary terms to make them valid and binding insurance," and that they were properly executed. (App.Vol.4.p.903.) Once again, however, the court appropriately looked beyond the formalities, agreeing with the Commissioner that the direct-written policies were "cookie cutter" policies, consisting of copyrighted language cut-and-pasted into arrangements for Capstone's clients.

(App.Vol.4.p.903.) This finding demonstrates the fallacy of taxpayer's constant refrain that it was formed with the goal of providing specialized coverage. (*See, e.g.,* App.Vol.5.p.1372 (Feldman testifying that Capstone-managed captives offered coverages designed "with a scalpel"); App.Vol.7.p.2031 (passage from feasibility study reciting that "Peak further desires a risk management option that would allow manuscripted coverage to address specific concerns . . ."); Br. 1 ("This case arises from a company's need for specialized insurance coverage . . .").)

Moreover, in its haste to issue policies prior to the close of the 2008 tax year, taxpayer issued two policies that erroneously identified Pacific Arts Entertainment, LLC, and Pacific Arts Presents, LLC – not Peak, RocQuest, and ZW – as the insureds. (App.Vol.8.p.2278, 2358.) Taxpayer also issued an excess directors-and-officers policy that failed to identify any covered individuals. (App.Vol.8.p.2314.) These errors and omissions highlight just how little importance taxpayer assigned to providing "specialized" coverage.[12]

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[12] Amici point out that an insurance policy need not be "custom written–i.e., manuscripted" to be enforceable. (Amicus

#### 4. Whether premiums were reasonable and the result of arm's-length dealing

The Tax Court found "a number of factors which indicate that the premiums . . . under the direct written policies were not reasonable in relation to the risk of loss." (App.Vol.4.p.905.) As the starting point for its analysis, the court noted that Peak's insurance expenses dramatically increased as a result of the captive arrangement. (App.Vol.4.p.905.) For the two-and-a-half-year period from January 2006 through June 2008, Peak paid commercial insurers an average of approximately $80,000 in annual premiums. *Supra*, p. 6. After taxpayer was formed, Peak continued to maintain all its commercial insurance *plus* supplemental coverage that cost an average of approximately $440,000 per year – an increase in total expenses by a factor of six-and-a-half.[13] *Supra*, pp. 6-8.

11-14.) However, the Tax Court did not hold otherwise. It simply found that, under the circumstances present here, the use of cookie cutter policies undermined taxpayer's claim that it intended to create a real insurance arrangement. (App.Vol.4.p.903-04.)

[13] Although the supplemental insurance also covered RocQuest and ZW, the Tax Court aptly characterized those entities as "two affiliates that had no active business operations." (App.Vol.4.p.905.)

Furthermore, the court found that Peak did not have "a genuine need for acquiring additional insurance during the tax years at issue" that might support the reasonableness of the corresponding premiums as the product of arm's-length negotiations. (App.Vol.4.p.909); *see also Ross*, 401 F.2d at 470 (insurance must be based on actual "business need"). The risks to which Peak was subject from 2008 to 2010 were the same as the risks to which it was subject during the prior decade. (App.Vol.4.p.1135-36.) Indeed, Zumbaum was unable to explain which of Peak's risks were covered by its various supplemental policies. (App.Vol.4.p.1132-34.) And with the possible exception of pollution insurance (App.Vol.4.p.1124), taxpayer submitted no evidence that Peak ever attempted to obtain additional commercial coverage, even though taxpayer's expert acknowledged that pollution liability, intellectual property, "commercial property gap," "punitive damages wrap," cyber risk, and tax liability coverages were available in the commercial market. (App.Vol.12.p.3582-85.)

Further to the issue of business need, taxpayer was purportedly formed after Peak's owners reviewed a draft feasibility study (App.Vol.4.p.1125), but no draft was submitted into evidence. The final

study, provided well after taxpayer's formation, neither provided "information on the probability of a loss event that the direct written policies covered" nor "explain[ed] in detail how the direct written policies would supplement Peak's existing insurance." (App.Vol.4.p.908.) In fact, the study cautioned that Capstone was "not asked to and did not perform a risk management study which would have focused on the range of coverages and related limits." (App.Vol.7.p.2031.) The study further cautioned that it "should not be construed as a detailed insurance or risk management review that would be conducted by a broker or risk manager in advising a proposed insured of specific coverages to insure . . ." (App.Vol.7.p.2033.)

Zumbaum attempted to provide various business justifications for increasing Peak's coverage, but the court did not find them credible. Zumbaum's claim that Peak was concerned about growth is belied by Capstone's rating worksheets (which projected that sales would remain flat) and Peak's actual operations (the company shrank from 17 employees to 13). (App.Vol.3.p.853; App.Vol.4.p.907.) His claim that Peak was dissatisfied with its commercial insurer's handling of a $25,000 claim for snow damage is belied by (a) the fact that Peak

continued to maintain its policies with that insurer and (b) his inability to identify any supplemental policy that would have covered such a loss. (App.Vol.4.p.906-07.) And his claim that Peak was motivated to obtain "tax liability" coverage based on a recent payment of back taxes is belied by taxpayer's failure to present evidence regarding "the amount of that purported loss or the likelihood that something like it would happen again." (App.Vol.3.p.893, App.Vol.4.p.907.)

In addition, there was no evidence that, in the decade preceding taxpayer's formation, Peak experienced a single dollar of loss that would have been covered by its new supplemental insurance policies. (App.Vol.3.p.865, 892-93; App.Vol.4.p.906-07, 909; Br. 55.) To be sure, taxpayer and amici are correct that there is no requirement that an entity experience a loss before it has a genuine need for insurance. (Br. 4, 54-55; Amicus 7-11.) Fortuitous losses can occur notwithstanding a lack of historical precedent. But, as captive consultant Donald Riggin explained, the package of supplemental insurance obtained by the affiliated insureds, at a cost of over $400,000 per year, was unusual insofar as *none* of the 11 to 13 policies covered risks for which the insureds had a demonstrated history of loss.

(App.Vol.5.p.1483; App.Vol.6.p.1543.) In any event, the Tax Court did not hold that a prior loss is a prerequisite to a genuine need for insurance. It simply held that, when considered in connection with all the facts and circumstances, a ten-year absence of losses was one factor supporting its determination that Peak did not really need the supplemental insurance it obtained (which, in turn, undermines any claim that the corresponding premiums were the product of arm's-length negotiations and were therefore reasonable).[14] (App.Vol.4.p.903, 905-10.)

Even Peak's alleged need for the one type of supplemental coverage that, at first blush, might seem more justifiable than the other types – pollution liability – was overstated. As the Tax Court found, Peak's risk in this area was much narrower than it claimed.

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[14] Amici and taxpayer assert that the potential failure of Peak's equipment presented "catastrophic risk[s]" of property damage, injury, and death. (Amicus 10-11 (risk posed by failure of ventilation equipment); Br. 12-13 (risks posed by falling equipment and rocks, failure of ventilation equipment and pumps, and underground transport).) This is a red herring; the affiliated insureds' existing commercial policies covered such risks. (App.Vol.4.p.905 (commercial coverage included "personal injury and products/completed operations liability"); App.Vol.7.p.2049 (commercial coverage included products liability for "bodily injury and property damage"); *see generally* App.Vol.10.p.2763-3000; App.Vol.11.p.3001-100.)

(App.Vol.4.p.906.) Although Peak operated at a polluted site and cleaned equipment used at other polluted sites, there is no evidence that it used, transported, or produced pollutants. Peak's risk was thus limited to the possibility that it might accidentally release pollutants while cleaning contaminated equipment. (App.Vol.4.p.906; Br. 13.) Despite having processes in place that had managed this risk without incident for over a decade (App.Vol.4.p.906), taxpayer paid nearly as much for supplemental pollution coverage in 2008, 2009, and 2010 – $82,850, $60,750, and $60,750, respectively – as it did in prior years for all its commercial policies combined (App.Vol.11.p.3107, 3284; App.Vol.12.p.3422; *supra*, p. 6).

Taxpayer relies heavily on two experts, Michael Solomon and Esperanza Mead, to establish the reasonableness of the premiums it charged the affiliated insureds. (Br. 16, 53-54.) However, neither Solomon nor Mead compared taxpayer's premiums to premiums charged by unrelated third-party insurers (App.Vol.5.p.1256-57; App.Vol.5.p.1291-94); therefore, neither had a basis to determine whether taxpayer's premiums were commercially reasonable. Solomon merely opined that the aggregate premiums charged by taxpayer were

reasonable when compared to Capstone's internal pricing guidelines. (App.Vol.13.p.3887-89.) Similarly, Mead merely opined that the aggregate premiums charged by taxpayer were reasonable when compared to rates charged by other Capstone-managed captives. (App.Vol.13.p.3782-86.)

Finally, despite opining that the premium amounts were calculated using sound methods, Mead (like taxpayer) failed to explain various pricing anomalies. For example, in 2008, the affiliated insureds paid $55,233 for a "punitive wrap" policy with a $1 million limit that was retroactive to January 2005. (App.Vol.11.p.3208.) In both 2009 and 2010, the affiliated insureds paid $40,500 for 12 months of coverage under a punitive wrap policy with a $500,000 limit. (App.Vol.12.p.3376, 3502.) Neither Mead nor taxpayer explained "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." (App.Vol.4.p.905.)

In sum, the record amply supports the Tax Court's finding that "no unrelated party would reasonably agree to pay [taxpayer] the premiums that Peak and the other [affiliated] insureds did for the coverage provided by the direct-written policies." (App.Vol.4.p.910.)

### 5. Whether claims were paid

The Tax Court acknowledged that taxpayer paid the one claim that Peak filed during the years at issue. (App.Vol.4.p.910.) Although the court found that this factor "weighs slightly in taxpayer's favor," it justifiably afforded it little weight in light of the unusual and irregular manner in which taxpayer handled the claim. (App.Vol.4.p.910.)

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Weighing the foregoing factors, the Tax Court justifiably concluded that taxpayer's transactions were not insurance in the commonly accepted sense. Taxpayer nonetheless contends that the Commissioner's position in that regard is "inconsistent" with exempt-status determination letters that the IRS issued to 39 other Capstone-managed captives. (Br. 60 (citing App.Vol.19.p.5497-593).) Those determination letters, however, were based on the "assum[ption] [that the applicant's] operations will be as stated in [its] application." (*See*, *e.g.*, App.Vol.19.p.5497.) Suffice it to say that there is no evidence in the record regarding the 39 applicants' actual "operations."[15] In any

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[15] Taxpayer further suggests (Br. 60 & n.8) that the IRS "had favorably ruled" on all 39 applicants' substantive operations in terms of

event, as the Tax Court observed in declining to rely on them (App.Vol.3.p.898), such letters "may not be used or cited as precedent" (I.R.C. § 6110(k)(3); *see* I.R.C. § 6110(b)(1)(A)). Taxpayer concedes as much. (Br. 22 n.2.)

## II.

**The Tax Court correctly sustained the Commissioner's determination that amounts reported by taxpayer as income were, in fact, income and therefore subject to the tax imposed by I.R.C. § 881(a)**

### Standard of review

The Tax Court's resolution of this issue based on taxpayer's failure of proof – including taxpayer's failure to prove that the payments at issue were intended to be capital contributions – is reviewable for clear error. *See Washington Mutual, Inc. v. United States*, 856 F.3d 711, 721 (9th Cir. 2017) (failure of proof in tax refund case); *Christy v. Travelers*

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risk distribution and commonly accepted notions of insurance, but it cites (by cross-reference) only a half-dozen private letter rulings in support of that claim. And taxpayer fails to mention that four Capstone-managed captives received adverse determination letters and eight, like taxpayer, withdrew their applications before receiving a determination. (App.Vol.5.p.1379.)

*Indem. Co. of America*, 810 F.3d 1220, 1225 n.4 (10th Cir. 2016) (question of intent is factual).[16]

### A. The Tax Court did not err in holding that taxpayer failed to establish that the payments at issue were not taxable FDAP income

As we have just shown, taxpayer's arrangements did not constitute insurance for federal tax purposes, and taxpayer was therefore not an "insurance company" within the meaning of I.R.C. § 501(c)(15). Nor was taxpayer eligible to make an I.R.C. § 953(d) election to be treated as a domestic corporation for tax purposes. (App.Vol.4.p.911-12; I.R.C. § 953(d)(1)(B) (election limited to foreign corporations that would otherwise qualify as domestic insurance companies).) As a taxable foreign corporation, taxpayer was subject to a

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[16] In *Twenty Mile Joint Venture, PND, Ltd. v. Commissioner*, 200 F.3d 1268, 1275 (10th Cir. 1999), this Court applied *de novo* review to the issue "whether [a] disputed item is properly characterized as forgiveness of debt . . . or as [a] contribution to capital" on the ground that the issue was one of "ultimate fact." The case cited by the *Twenty Mile* court, however, referred to findings of "'ultimate fact derived from applying legal principles to subsidiary facts,'" *i.e.*, mixed questions of fact and law. 200 F.3d at 1275. To the extent the Tax Court's rejection of taxpayer's capital-contribution argument raises a mixed question of fact and law, we submit that clear-error review is more appropriate, since – as the Supreme Court held in *Chicago, Burlington & Quincy*, 412 U.S. at 411-12 – the issue turns primarily on the factual issue of intent. *Chicago, Burlington & Quincy*, 412 U.S. at 411; *see* p. 22, *supra*.

30-percent tax on "fixed or determinable annual or periodical gains, profits, and income" ("FDAP income") "received from sources within the United States," to the extent such amounts were "not effectively connected with the conduct of a trade or business within the United States." I.R.C. § 881(a)(1).

In its notice of deficiency, the IRS determined that amounts identified as income on taxpayer's returns constituted taxable FDAP income. (App.Vol.1.p.18.) Taxpayer "ha[d] the burden of establishing that the [Commissioner]'s determination of income . . . [was] incorrect." *Zell v. Commissioner*, 763 F.2d 1139, 1141 (10th Cir. 1985).

On appeal, taxpayer does not dispute that it had the burden of proving that the amounts at issue were not FDAP income. Nor does it dispute that it was a foreign corporation, that it received the payments from a U.S. source, or that the payments were fixed or determinable periodic remittances. Nor does taxpayer claim that such amounts were effectively connected with the conduct of a U.S. trade or business. Taxpayer's sole argument is that, because the Tax Court "determin[ed] that there was no non-tax reason for [taxpayer] to have received the

payments at issue . . . the only potentially applicable characterization is a contribution to capital." (Br. 67.) This argument fails.

The premise underlying taxpayer's argument is that "[e]ach of the alternative [characterizations] (other than a contribution to capital) described in Revenue Ruling 2005-40 are inconsistent with" the Tax Court's finding that there was no real business purpose for the policies that taxpayer issued to the affiliated insureds. But the cited revenue ruling does not provide an exhaustive list of possible characterizations; rather, it states that a purported insurance arrangement

> may instead be characterized as a deposit arrangement, a loan, a contribution to capital (to the extent of net value, if any), an indemnity arrangement that is not an insurance contract, *or otherwise*, based on the substance of the arrangement between the parties.

Rev. Rul. 2005-40, 2005-2 C.B. 4, at *1 (emphasis added). In the proceedings below, taxpayer argued that the payments should be characterized as nontaxable contributions to capital, advances, or deposits. (App.Vol.3.p.636-38.) The Commissioner argued that the payments should be characterized as amounts moved offshore to self-insure against business losses – analogous to underwriting or guarantee income under I.R.C. § 861(a)(7) and (a)(9) – and subject to tax under

I.R.C. § 881(a). (App.Vol.4.p.944-47); *cf. Centel Commc'ns Co. v. Commissioner*, 920 F.2d 1335, 1343-44 (7th Cir. 1990) (in considering whether payments constitute U.S.-sourced income, it is appropriate to proceed by analogy to the categories of income in I.R.C. § 861).

Distinguishing between such characterizations necessarily requires consideration of all the facts and circumstances. In evaluating taxpayer's argument that the payments at issue here should be characterized as nontaxable capital contributions, the controlling consideration is "the intent or motive of the transferor." *Chicago, Burlington & Quincy*, 412 U.S. at 411-12 (reconciling *Detroit Edison Co. v. Commissioner*, 319 U.S. 98 (1943), and *Brown Shoe Co. v. Commissioner*, 339 U.S. 583 (1950), on that basis); *Hayutin*, 508 F.2d at 480 (citing *Detroit Edison* and *Brown Shoe*).[17]

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[17] Although *Hayutin* and the Supreme Court cases cited above address nonshareholder contributions to capital, "the payor's motive controls . . . whether the payor is a nonshareholder . . . or a shareholder." *Board of Trade v. Commissioner*, 106 T.C. 369, 381 (1996) (citations omitted); *see also Betson v. Commissioner*, 802 F.2d 365, 371 (9th Cir. 1986) (sole shareholder); *James Hotel Co. v. Commissioner*, 325 F.2d 280, 282 (10th Cir. 1963) (referring to the "'apparent intent'" of the member-stockholders).

Here, the Tax Court found that taxpayer had identified no evidence supporting its position that the payments should be characterized as capital contributions. (App.Vol.4.p.913-14.) On appeal, taxpayer neither disputes that finding nor identifies any supporting evidence. This failure to put forward evidence is sufficient, in its own right, to sustain the IRS's determination that the payments were FDAP income. *See Welch v. Helvering*, 290 U.S. 111, 115 (1933); *Anaya v. Commissioner*, 983 F.2d 186, 188 (10th Cir. 1993); *Jones v. Commissioner*, 903 F.2d 1301, 1303-06 (10th Cir. 1990).

Relying on the Tax Court's decision in *Board of Trade v. Commissioner*, taxpayer argues that "'[d]irect proof of the motive of the payor is rarely available.'" (Br. 64 (quoting 106 T.C. at 382.) Here, though, taxpayer had the opportunity to develop such direct proof through Zumbaum's testimony. And regardless of the availability of direct proof, taxpayer provides no explanation for its failure to develop indirect proof.

Moreover, some evidence of intent can be derived from the manner in which Peak and taxpayer treated the payments on their tax returns. Peak reported the payments as deductible expenses (App.Vol.4.p.1133;

App.Vol.9.p.2670, 2685), which is inconsistent with capital-contribution status. *Commissioner v. Fink*, 483 U.S. 89, 94 (1987). Taxpayer likewise reported the payments as income, not capital contributions. (App.Vol.6.p.1596, 1610, 1615, 1628, 1653, 1661.)

This treatment also has significance beyond its evidentiary value. Having chosen to structure and report its arrangements in a particular form, taxpayer should not be allowed to disavow that form and argue that the arrangements were, in substance, something else. *See Commissioner v. National Alfalfa Dehydrating & Milling Co.,* 417 U.S. 134, 149 (1974); *Guaderrama v. Commissioner*, 21 F. App'x. 858, 860-62 (10th Cir. 2001) (unpublished) (citing *Hamlin's Trust v. Commissioner*, 209 F.2d 761, 765 (10th Cir. 1954)) (taxpayer cannot disavow chosen form of transaction without, at a minimum, presenting "strong proof" that different arrangement was intended); *Uri v. Commissioner*, 949 F.2d 371, 373-74 n.4 (10th Cir. 1991) (substance-over-form doctrine allows Government, not taxpayers, to recharacterize transaction). Taxpayer has not provided any proof, let alone strong proof, that the amounts received were capital contributions. Indeed, taxpayer is attempting to recast the payments from its perspective (*i.e.*, as capital

contributions from its indirect owners, Zumbaum and Weikel) without a symmetrical recasting of those same payments from the affiliated insureds' perspective (*i.e.*, as nondeductible distributions to their owners, Zumbaum and Weikel, for contribution to taxpayer). In doing so, taxpayer turns the purpose of the substance-over-form doctrine – "to recharacterize transactions in accordance with their true nature" – on its head. *Rogers v. United States*, 281 F.3d 1108, 1115 (10th Cir. 2002) (citation and internal quotations omitted).

**B. The authorities cited by taxpayer are inapposite**

Taxpayer's reliance (Br. 66-67) on *Carnation Co. v. Commissioner*, 71 T.C. 400 (1978), *aff'd*, 640 F.2d 1010 (9th Cir. 1981), is misplaced. There, the Commissioner used the substance-over-form doctrine to recharacterize purported insurance premiums as capital contributions. 71 T.C. at 415. Although the insured argued that the arrangements at issue were *bona fide* insurance contracts, it did not advance an alternative characterization if the court found otherwise. *Id.* Consequently, the court affirmed the Commissioner's determination based on the presumption of correctness that attached thereto; it had no occasion to elucidate the facts and circumstances under which

purported insurance premiums should be recharacterized as capital contributions. *Id.*; *compare Gulf Oil*, 914 F.2d at 412-13 (finding that arrangements did not constitute insurance contracts for tax purposes but declining, under the circumstances, to recharacterize payments made thereunder as capital contributions).

Also misplaced is taxpayer's reliance (Br. 65-66) on Rev. Rul. 78-83, 1978-1 C.B. 79. As a threshold matter, taxpayer first raised the ruling's potential applicability in its post-opinion motion for reconsideration (App.Vol.4.p.921, 924-27), which is insufficient to preserve the argument for appeal. *Servants of Paraclete v. Does*, 204 F.3d 1005, 1012 (10th Cir. 2000). In any event, the ruling is inapposite. There, two foreign subsidiaries with a common domestic parent shifted income from the first subsidiary to the second by having the latter charge excessive fees for services. Rev. Rul. 78-83 at *1. The ruling concludes that the reallocation of the excess compensation under I.R.C. § 482 results in a constructive distribution from the first subsidiary to the domestic parent, followed by a capital contribution to the second subsidiary. *Id.* at *2. Here, there was no reallocation to make because the IRS determined that the arrangements did not

constitute insurance at all, not that they constituted insurance for which taxpayer charged excessive premiums.[18] At all events, inasmuch as revenue rulings are generally limited to their facts, the reallocation of excess payments between controlled subsidiaries "does not *necessarily* result in a constructive distribution." *Bittker & Eustice: Federal Income Taxation of Corps. and Shareholders*, ¶ 8.06[10] at *9 (2020) (emphasis added); *cf. Sammons v. Commissioner*, 472 F.2d 449, 453-56 (5th Cir. 1972) (whether excess payments should be recharacterized as constructive dividends depends on facts and circumstances).

## CONCLUSION

The decision of the Tax Court should be affirmed.

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[18] Other authority on which taxpayer relies (Br. 66) is also distinguishable on this basis. *See* Rev. Rul. 69-630, 1969-2 C.B. 112, at *1 (reallocating excess sales price); *Commissioner v. Greenspun*, 156 F.2d 917, 921 (5th Cir. 1946) (reallocating excess rental payments).

## STATEMENT REGARDING ORAL ARGUMENT

This appeal presents the question of whether taxpayer qualifies as an insurance company for federal tax purposes, based on its participation in a series of purported reinsurance arrangements administered by a commonly controlled entity. Due to the administrative importance of this issue, counsel for the Commissioner respectfully submit that oral argument would be helpful.

Respectfully submitted,

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JULY 2020

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