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

Petitioner,

ELECTRONICALLY FILED

v.

Docket No. 14545-16

COMMISSIONER OF INTERNAL REVENUE,

Respondent

RESPONDENT'S SIMULTANEOUS OPENING BRIEF

UNITED STATES TAX COURT

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

SIMULTANEOUS OPENING BRIEF FOR RESPONDENT

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SIMULTANEOUS OPENING BRIEF FOR RESPONDENT

PRELIMINARY STATEMENT

Petitioner seeks a redetermination of deficiencies in income tax determined by respondent as follows:

Tax Year	Deficiency
2008	$144,538.00
2009	$164,418.00
2010	$168,305.00

This case was tried at a regular session of the Court before the Honorable Judge Kathleen Kerrigan beginning on April 27, 2017 through May 2, 2017, at Houston, Texas. The evidence consists of the pleadings, Stipulation of Facts ("Stip. ¶") (consisting of paragraphs 1 through 95, inclusive) with attached Exhibits ("Ex.") (consisting of 1-J through 4-J, 5-R through 7-R, 8-J through 27-J, 28-P through 30-P, 31-J through 96-J; 97-P,

99-R through 102-R, 103-P, 104-P, 107-P through 114-P, 115-R, 116-R, 117-P, 118-R through 122-R, 123-P through 133-P, 136-R, 137-R, 138-P through 142-P, 143-J through 146-J, 147-P, 149-J through 153-J); and oral testimony ("Tr.") (consisting of pages 1 through 1043).

Pursuant to the Court's Orders dated May 2, 2017, and July 28, 2017, simultaneous opening briefs are due on or before August 4, 2017. Answering briefs are due on or before September 29, 2017. The Court further ordered that each party's opening brief may not exceed 100 pages and each party's answering brief may not exceed 60 pages. Such page limitations do not apply to the table of contents.

QUESTIONS PRESENTED

1. Whether petitioner's insurance[1] and reinsurance transactions, including the payment of premiums, lack economic substance.

2. Whether petitioner's captive insurance arrangement qualifies as insurance for federal income tax purposes, and consequently, whether petitioner was exempt from taxation under section 501(a) as an "insurance company" described in section 501(c)(15) of the Internal Revenue Code.[2]

3. Whether petitioner is described in section 501(c)(15) and is therefore eligible to make an election under section 953(d) to be treated as a domestic corporation.

4. Whether petitioner is subject to the 30 percent tax imposed by section 881(a) for the taxable years 2008, 2009, and 2010 and is therefore required to file a U.S. Income Tax Return of a Foreign Corporation (Form 1120-F) for each of those taxable years.

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[1] As agreed to in the Stipulation of Facts, respondent's use of terms, and defined terms such as "policy", "premium", "insurance", "risks", "reinsurance", "coverage", and "insured", including all derivatives, are for convenience and not intended to be construed as a concession that the arrangement at issue should be recognized as insurance for federal income tax purposes. Respondent's use of these terms mirrors the labels assigned to the transaction by petitioner, their agents, and related parties.

[2] All section references are to the Internal Revenue Code as in effect during the taxable years at issue.

RESPONDENT'S REQUEST FOR FINDINGS OF FACT

Respondent requests the Court to find the following facts:

I. Preliminary Matters

1. Petitioner filed Form 990, Return of Organization Exempt from Income Tax or 990-EZ, Short Form Return of Organization Exempt From Income Tax ("Forms 990"), for each of the taxable years 2008, 2009, and 2010 ("the taxable years at issue"). (Stip. ¶ 3; Exs. 2-J, 3-J, 4-J)

2. On its Forms 990, petitioner reported gross income exempt from tax under section 501(c)(15) in the amounts of $481,792, $548,059, and $561,017 for the taxable years 2008, 2009 and 2010, respectively. (Exs. 2-J, 3-J, 4-J)

3. Petitioner elected under section 953(d) to be taxed as a United States corporation for federal tax purposes for the taxable years at issue. (Stip. ¶ 19; Ex. 19-J)

4. The notice of deficiency, upon which this case is based, was timely mailed to petitioner at its last known address on March 29, 2016. (Stip. ¶ 2; Ex. 1-J)

II. Norman Zumbaum and Corey Weikel Own All of the Involved Entities

5. Norman Zumbaum ("Zumbaum") and Corey Weikel ("Weikel") are individuals and residents of Idaho. (Stip. ¶ 27)

6. During the taxable years at issue, Zumbaum and Weikel owned directly or indirectly all of the entities involved in the

purported insurance arrangement at issue, consisting of petitioner, Peak Mechanical & Components, Inc. ("Peak"), RocQuest LLC ("RocQuest"), and ZW Enterprises LLC ("ZW Enterprises"). (Stip. ¶¶ 25, 26, 46, 47)

A. Petitioner

7. Petitioner was 100 percent owned by Peak Casualty Holdings, LLC ("Peak Casualty"). (Stip. ¶ 25)

8. Peak Casualty was co-equally owned by Zumbaum and Weikel. (Stip. ¶ 26)

9. During the taxable years at issue, Zumbaum was a director and also served as the Chief Executive Officer, President, Treasurer, and Assistant Secretary of petitioner. (Stip. ¶¶ 28, 29)

10. During the taxable years at issue, Weikel was a director and also served as the Vice President, Secretary, and Assistant Treasurer of petitioner. (Stip. ¶¶ 28, 30)

B. Peak

11. Zumbaum and Weikel were the sole shareholders and officers of Peak. (Stip. ¶ 26)

12. Peak is engaged in the business of repairing, servicing, and manufacturing equipment used in mining and construction. (Stip. ¶ 50)

13. During the taxable years at issue, Peak had 17 employees, including two outside sales persons, two shop managers, and ten shop staff. (Ex. 16-J; Tr. 315)

14. Peak is located on the Bunker Hill EPA Superfund site in Osburn, Idaho, which is polluted with lead and zinc as a result of years of mining. (Stip. ¶ 51; Tr. 110)

C. RocQuest and ZW Enterprises

15. Zumbaum and Weikel co-equally own RocQuest and ZW Enterprises. (Stip. ¶ 46, 47)

16. RocQuest and ZW Enterprises are located in Osburn, Idaho. (Stip. ¶ 51)

17. RocQuest holds real estate located in Idaho and Nevada, which is leased to Peak. (Tr. 107-108)

18. ZW Enterprises financed the purchase of a bar in Idaho and its operations are not otherwise significant. (Tr. 109)

III. Peak Maintained its Commercial Insurance Coverage with Third Party Insurers

19. At all times during the taxable years at issue, Peak maintained comprehensive commercial insurance policies and coverages with third party insurers as follows:

Insurer	Policy	Coverage
Employers Mutual Casualty Company	General Liability	
	• Each Occurrence	$1,000,000
	• General Aggregate	$2,000,000
	• Products/Comp Op Agg	$2,000,000
	• Personal & Adv	$1,000,000
	• Damage to Rent Prem	$100,000
		$5,000

	• Medical Expense	
Idaho State Insurance Fund	Workers Compensation Employers Liability • Each Accident • Disease - Policy Limit • Disease - Each Employee	 $100,000 $500,000 $100,000
Employers Mutual Casualty Company	Property • Blanket Policy Limit	 $914,940
Employers Mutual Casualty Company	Inland Marine - EDP • Limit Hardware	 $8,000
Ace American Insurance Company	International Risk Policy • Foreign GL, Al, and EL • Foreign AD&D • Kidnap & Extortion	 $1,000,000 $5,000 $50,000

(Ex. 16-J)

20. In 2006, Peak deducted insurance expenses in the amount of $38,810. (Ex. 34-J)

21. In 2007, Peak deducted insurance expenses in the amounts of $95,828. (Ex. 34-J)

22. In 2008, prior to the formation of petitioner, Peak paid approximately $40,000 in commercial insurance policy premiums. (Ex. 34-J)

23. During the taxable years at issue, Peak made no changes to their commercial insurance policies or coverages obtained from third party insurers. (Tr. 158)

IV. Peak and Zumbaum had Insignificant Insurance Experience Prior to Formation of Petitioner

24. During the taxable years at issue, Zumbaum did not investigate or conduct any due diligence regarding insurance companies in Idaho that could provide additional insurance coverage to Peak. (Tr. 124)

A. Pre-2008 Auto Claims

25. Prior to 2008, the only insurance claims made by Peak, through Zumbaum, related to losses due to operation of company vehicles. (Tr. 159)

B. 2008 Roof Damage

26. In 2008, a building owned by Peak had a significant amount of snow accumulate on the roof, which caused the roof to stretch. (Tr. 122)

27. Zumbaum contacted Peak's third party insurer, Employers Mutual Casualty Company ("EMC"), regarding the damage to the building caused by the stretched roof. (Tr. 122-123)

28. EMC sent engineers and experts to assess the roof damage and determined that the cost of repair was $2,000. (Tr. 122)

29. Zumbaum decided to replace the roof entirely instead of making the $2,000 repair. (Tr. 123)

30. From the date of the incident with the snow accumulation on the roof through the taxable years at issue,

Zumbaum maintained Peak's insurance policy and coverage with EMC. (Tr. 159)

C. Prior Loss History of Peak, RocQuest, and ZW Enterprises

31. Respondent subpoenaed Peak, RocQuest and ZW Enterprises to provide documents relating to communications with third party insurers, which would have included claim submissions, letters, and cancelled checks regarding the payment of a claim. (Exs. 100-R, 101-R, 102-R)

32. Peak, RocQuest, and ZW Enterprises did not produce any documents relating to communications with third party insurers in response to respondent's subpoenas. (Tr. 174)

33. There is no evidence that RocQuest and ZW Enterprises had any history of losses. (Entire record)

34. There is no evidence that Peak had any history of losses beyond those resulting from operation of company vehicles and from the accumulation of snow on a building's roof. (Entire Record)

V. Capstone and the Feldman Law Firm Created the Purported Insurance Arrangement

35. Capstone Associated Services ("Capstone") is a turnkey captive management and captive formation company. (Tr. 40, 779)

36. When working with a client to create a captive, Capstone performs all services, including the feasibility study, identification of captive domicile, conducting regulatory

filings, and providing accounting and legal services in the ongoing operation of the captive. (Tr. 41)

37. Capstone was formed in 1998 by Stewart Feldman ("Feldman"), an attorney, who serves as its chief executive officer and general counsel. (Tr. 615-616)

38. Feldman is also the managing partner of Feldman Law Firm LLP ("Feldman Law Firm"). (Tr. 616-617)

39. Capstone is a subset, or a business within the business, of Feldman Law Firm. (Tr. 40)

40. Shortly before the formation of petitioner, Zumbaum discussed captive insurance with a colleague, Bob Pope. (Tr. 124-125)

41. During the discussion with Bob Pope, Zumbaum did not discuss concerns with lacking insurance coverage or the need for additional insurance coverage for Peak. (Tr. 154-155)

42. Bob Pope recommended Capstone to Zumbaum. (Tr. 124-125)

43. Peak selected Capstone and Feldman Law Firm to assist in establishing and servicing petitioner. (Tr. 125)

44. There is no evidence that Peak consulted with anyone other than Capstone to investigate the risks associated with the captive insurance arrangement at issue or to determine the potential risk exposures, if any, for Peak, RocQuest, and ZW Enterprises. (Entire Record)

45. There are no engagement letters, invoices, or billing statements evidencing amounts paid for any services performed by Capstone on behalf of petitioner during the taxable years at issue. (Entire Record)

A. Peak's Feasibility Study Created by Capstone

46. Capstone prepared a document for Peak entitled "Captive Insurance Company Feasibility Study for Peak Mechanical & Components, Inc. - Initial Site Visit: August 13, 2008" ("Feasibility Study"). (Ex. 16-J)

47. According to Zumbaum, there was no payment for the Feasibility Study or for Capstone's expenses related to the Feasibility Study. (Tr. 160)

48. According to Feldman, Capstone charged Peak between $15,000 and $20,000 for the Feasibility Study, including travel expenses for Capstone personnel. (Tr. 318, 698)

49. Lance McNeel ("McNeel") was the director of the insurance operation of the insurance department at Capstone during the taxable years at issue. (Tr. 297)

50. On or about August 13, 2008, McNeel and Feldman conducted the site visit to Peak in connection with the Feasibility Study. (Tr. 44, 306, 378, 685)

51. The site visit to Peak lasted between six to eight hours. (Tr. 310)

52. The packet of background information on Peak contained in Exhibit 34-J (the "Background Information") was provided by Peak to Capstone at the time the Feasibility Study was being prepared. (Ex. 34; Tr. 24-25)

53. The Background Information was gathered by Peak. (Ex. 34; Tr. 311)

54. The Background Information was reviewed by Capstone prior to the site visit on or about August 13, 2008, or shortly thereafter. (Tr. 311)

55. The Feasibility Study was drafted by McNeel. (Tr. 26)

56. The Feasibility Study states that it is "the sole exclusive property of Capstone Associated Service, Ltd. and no copies, summaries, nor extracts thereof may be made, distributed, or used for any purpose without the express written consent of Capstone Associated Services, Ltd." (Ex. 16-J)

57. The Feasibility Study states that Peak's Board of Directors has "selected The Feldman Firm Law Firm, LLP [sic] and Capstone Associated Services, Ltd. to assist in the formation and servicing of a potential new small captive should it be determined to be feasible." (Ex. 16-J)

58. Petitioner's expert, Dr. Neil Doherty ("Doherty"), could only recall one or two times other than with Capstone, that a captive manager advised a client, conducted the

feasibility study, compiled the background information, and went on to manage the captive. (Tr. 280)

B. The Feasibility Study Errors

59. The Feasibility Study does not discuss the operations of Rocquest and ZW Enterprises. (Ex. 16-J)

60. McNeel does not have experience with the mining industry in Idaho or with any company located in an EPA Superfund site. (Tr. 386)

61. Regarding Peak's loss history, McNeel was only aware of Peak's claim in 2008 relating to snow accumulation on the roof while drafting the Feasibility Study. (Tr. 405)

62. Robert Snyder ("Snyder") reviewed and signed off on the Feasibility Study. (Tr. 25-26)

63. Snyder did not second-guess the work of McNeel and relied upon McNeel's conclusions for the Feasibility Study. (Tr. 59)

64. Snyder's expertise regarding insurance is in the healthcare industry. (Tr. 47)

65. Snyder has no experience with manufacturing and fabrication of devices in the mining industry. (Tr. 48)

66. The Feasibility Study ultimately concluded that Peak did not have commercial auto insurance. (Ex. 16-J)

67. The Background Information includes commercial auto insurance coverage for Peak from State Farm, which was in effect within weeks of the initial site visit. (Ex. 34-J, Ex. 16-J)

C. Issuance of 2008 Policies

68. In 2008, petitioner issued thirteen direct written contracts for insurance coverages for Peak, RocQuest and ZW Enterprises for the period December 4, 2008 through January 1, 2009 ("2008 Contracts"). (Stip. ¶ 52)

69. Petitioner was paid $412,089 in policy premiums by Peak for less than one month of coverage for the 2008 Contracts. (Ex. 35-J)

70. Effective as of December 4, 2008, petitioner issued the 2008 Contracts for insurance coverage for Peak, RocQuest and ZW Enterprises as follows:

No.	Policy	Aggregate Limit	Policy Premium
1.	Special Risk - Loss of Customer	$1,000,000	$7,268
2.	Employment Practices Liability	$1,000,000	$24,256
3.	Special Risk - Regulatory Changes	$1,000,000	$64,899
4.	Directors and Officers Liability	$1,000,000	$17,122
5.	Special Risk - Loss of Services	$1,000,000	$4,874
6.	Special Risk - Expense Reimbursement	$1,000,000	$31,312
7.	Pollution Liability	$1,000,000	$82,850
8.	Special Risk - Tax Liability	$1,000,000	$65,408

9.	Intellectual Property Package	$1,000,000	$18,169
10.	Cyber Risk Package	$1,000,000	$28,343
11.	Special Risk – Punitive Wrap	$1,000,000	$55,233
12.	Special Risk – Weather Related Business Interruption	$1,000,000	$7,268
13.	Special Risk – Product Recall	$1,000,000	$5,087
	Total	**$13,000,000**	**$412,089**

(Stip. ¶ 55; Exs. 36-J, 37-J, 38-J, 39-J, 40-J, 41-J, 42-J, 43-J, 44-J, 45-J, 46-J, 47-J, 48-J)

71. The 2008 Contract for "Special Risk – Loss of Major Customer" did not have a retroactive date or "look-back" period. (Ex. 37-J)

72. The 2008 Contract for "Special Risk – Expense Reimbursement" did not have a retroactive date or "look-back" period. (Ex. 38-J)

73. The 2008 Contract for "Special Risk – Loss of Services" did not have a retroactive date or "look-back" period. (Ex. 39-J)

74. The 2008 Contract for "Special Risk – Weather Related Business Interruption" did not have a retroactive date or "look-back" period. (Ex. 40-J)

75. The 2008 Contract for "Special Risk – Regulatory Changes" did not have a retroactive date or "look-back" period. (Ex. 44-J)

76. The 2008 Contract for "Special Risk - Product Recall" did not have a retroactive date or "look-back" period. (Ex. 48-J)

77. Petitioner entered into a contract for reinsurance on November 26, 2008, several days before Anguilla issued a Class B Insurance license to petitioner. (Exs. 52-J, 10-J; Tr. 452-453)

78. Petitioner entered into a Quota Share Reinsurance Policy arrangement for the 2008 year. (Ex. 51-J)

79. Petitioner entered into a Credit Coinsurance Reinsurance Program arrangement for the 2008 year, effective November 26, 2008. (Ex. 52-J)

D. Issuance of 2009 Policies

80. In 2009, petitioner issued eleven direct written contracts for insurance coverage for Peak, RocQuest and ZW Enterprises for the period January 1, 2009 to January 1, 2010 ("2009 Contracts"). (Stip. ¶ 68)

81. Petitioner was paid $448,127 in policy premiums by Peak for the 2009 Contracts. (Ex. 59-J)

82. Effective January 1, 2009, petitioner issued the 2009 Contracts for insurance coverage for Peak, RocQuest and ZW Enterprises as follows:

No.	Policy	Aggregate Limit	Policy Premium
1.	Special Risk - Loss of Customer	$500,000	$50,625

2.	Special Risk - Regulatory Changes	$500,000	$47,588
3.	Directors and Officers Liability	$1,000,000	$17,075
4.	Special Risk - Loss of Services	$1,000,000	$62,791
5.	Special Risk - Expense Reimbursement	$1,000,000	$26,686
6	Pollution Liability	$500,000	$60,750
7.	Special Risk - Tax Liability	$500,000	$45,562
8.	Intellectual Property Package	$1,000,000	$34,425
9.	Special Risk - Punitive Wrap	$500,000	$40,500
10.	Special Risk - Product Recall	$500,000	$35,438
11.	Legal Expense Reimbursement	$1,000,000	$26,687
	Total	**$8,000,000**	**$448,127.00**

(Stip. ¶ 71; Ex. 60-J, 61-J, 62-J, 63-J, 64-J, 65-J, 66-J, 67-J, 68-J, 69-J, 70-J)

83. Petitioner provided no evidence to explain why it dropped the Cyber Risk Package and Special Risk - Weather Related Business Interruption contracts, and has not provided any evidence to explain why it reduced the aggregate policy limit from $1,000,000 to $500,000 for six of its policies. (Entire Record)

84. Petitioner entered into a Quota Share Reinsurance Policy arrangement for the 2009 year. (Ex. 71-J)

85. Petitioner entered into a Credit Coinsurance Reinsurance Program arrangement for the 2009 year. (Ex. 72-J)

E. Completion of Feasibility Study

86. The final Feasibility Study was issued in August 2009. (Tr. 402)

87. The Background Information used to draft the final Feasibility Study includes information dated December 14, 2009. (Ex. 34-J)

F. Submission of Form 1024 Application

88. On August 31, 2009, Zumbaum submitted on behalf of petitioner a Form 1024 Application for Recognition of Exemption Under Section 501(a) ("Form 1024"). (Ex. 19-J)

89. The Form 1024 was signed by Zumbaum under penalty of perjury. (Ex. 19-J, at RSV-0005696)

90. Zumbaum examined the Form 1024 application, including the accompanying schedules and attachments, and certified that they were true, correct, and complete. (Ex. 19-J, at RSV-0005696)

91. The insurance policies issued by petitioner during 2008 were attached to the Form 1024 as Exhibit E3. (Ex. 19-J)

92. Petitioner included in the Form 1024, at Exhibit E3, a copy of the insurance policy for excess directors & officers liability issued by petitioner for 2008. (Ex. 19-J, at RSV-0005875)

93. Petitioner omitted the named insured persons on Schedule 1-A to the 2008 excess directors & officers liability attached to the Form 1024. (Ex. 19-J, at RSV-0005885)

94. Petitioner included in the Form 1024, at Exhibit E3, a copy of the insurance policy for tax liability issued by petitioner for 2008. (Ex. 19-J, at RSV-0005968)

95. The 2008 tax liability insurance policy insured Pacific Arts Entertainment, LLC ("PAE") and Pacific Arts Presents, LLC ("PAP"). (Ex. 19-J, at RSV-0005972)

96. The notice of claim address for the 2008 tax liability insurance policy, reflecting PAE and PAP as named insureds, is petitioner's Anguillan address. (Ex. 19-J, at RSV-0005974)

97. Petitioner included in the Form 1024, at Exhibit E3, a copy of the insurance policy for regulatory changes issued by petitioner for 2008. (Ex. 19-J, at RSV-0005843)

98. The 2008 regulatory changes insurance policy insured PAE and PAP. (Ex. 19-J, at RSV-0005847)

99. The notice of claim address for the 2008 tax liability insurance policy, again reflecting PAE and PAP as named insureds, is petitioner's Anguillan address. (Ex. 19-J, at RSV-0005848)

G. Issuance of 2010 Policies

100. In 2010, petitioner issued eleven direct written contracts for insurance coverage for Peak, RocQuest and ZW

Enterprises for the period January 1, 2010 to January 1, 2011 ("2010 Contracts"). (Stip. ¶ 76)

101. Petitioner received $445,314 in policy premiums for the 2010 Contracts. (Ex. 74-J)

102. Effective January 1, 2010, petitioner issued the 2010 Contracts for insurance coverage for Peak, RocQuest, and ZW Enterprises as follows:

No.	Policy	Aggregate Limit	Policy Premium
1.	Excess Directors and Officers Liability	$1,000,000	$17,075
2.	Special Risk - Expense Reimbursement	$1,000,000	$23,024
3.	Excess Intellectual Property Package	$1,000,000	$34,425
4.	Legal Expense Reimbursement	$1,000,000	$30,349
5.	Special Risk - Loss of Customer	$500,0000	$47,812
6.	Special Risk - Loss of Services	$1,000,000	$62,791
7.	Excess Pollution Liability	$500,000	$60,750
8.	Special Risk - Punitive Wrap	$500,000	$40,500
9.	Special Risk - Product Recall	$500,000	$35,438
10.	Special Risk - Regulatory Changes	$500,000	$47,588
11.	Special Risk - Tax Liability	$500,000	$45,562
	Total	**$8,000,000**	**$445,314**

(Stip. ¶ 79; Exs. 75-J, 76-J, 77-J, 78-J, 79-J, 80-J, 81-J, 82-J, 83-J, 84-J, 85-J)

103. Petitioner entered into a Quota Share Reinsurance Policy arrangement for the 2010 year. (Ex. 86-J)

104. Petitioner entered into a Credit Coinsurance Reinsurance Program arrangement for the 2010 year. (Ex. 87-J)

VI. Petitioner did not Conduct its Operations like a Commercial Insurer

A. Petitioner's Domicile and Interactions with Anguilla

i. Atlas Insurance Management

105. Atlas Insurance Management ("Atlas") was engaged by Capstone as of December 1, 2006 to perform captive management services for Capstone clients. (Tr. 508; 119-R)

106. Atlas transmitted documents to the Anguillan insurance regulator in connection with petitioner's initial application process. (Tr. 509; 120-R)

107. The documents transmitted by Atlas to the Anguillan insurance regulator were prepared by Capstone. (Tr. 509)

108. After the initial application, Atlas continued to operate as a regulatory liaison and provided a local office in Anguilla. (Tr. 509)

109. On October 21, 2008, Zumbaum and Weikel, as officers and directors of petitioner, and Feldman, on behalf of Capstone, signed an Application for a Class B Insurance License in Anguilla (the "Application") for petitioner. (Stip. ¶ 8)

110. On December 3, 2008, petitioner was formed and incorporated in Anguilla, British West Indies, under the provisions of Section 9 of the Companies Act, 2000. (Stip. ¶ 7; Tr. 128)

111. On December 10, 2008, petitioner was capitalized with $100,000. (Ex. 28-P)

112. Petitioner selected Anguilla as its domicile because Anguilla is a younger captive domicile, and the regulatory environment is more flexible and much more efficient in granting new licenses. (Stip. ¶ 7; Ex. 17-J)

113. The Financial Services Commission of Anguilla issued a Class B: General Insurance License to petitioner for the taxable years at issue. (Stip. ¶ 10, 11, 12; Exs. 10-J, 11-J, 12-J)

ii. Capstone Insurance Management, Anguilla

114. On June 30, 2009, the relationship between Atlas and Capstone changed as Capstone formed Capstone Insurance Management Anguilla ("CIMA"), which is a Capstone-owned licensed insurance management company in Anguilla. As a result of the formation of CIMA, Capstone no longer needed Atlas involved with petitioner. (Tr. 509; 122-R)

115. After June 30, 2009, the management of petitioner changed from Atlas to CIMA. (Tr. 518; 122-R)

116. During the taxable years at issue, Zumbaum was unfamiliar with, and had no actual knowledge of, petitioner's operations in Anguilla. (Tr. 166)

117. Petitioner has not produced any documents to evidence the management services performed by CIMA for petitioner during the taxable years at issue. (Entire Record)

118. Petitioner has not produced any documents to substantiate payment by petitioner for any management services performed by CIMA on its behalf during the taxable years at issue. (Entire Record)

119. Respondent subpoenaed documents from Peak, RocQuest, and ZW Enterprises including engagement letters, invoices, Board of Directors meeting minutes, billing statements, contracts, correspondence, time records, statements of work performed, and receipts with respect to the insurance services performed by petitioner and third party insurance companies. (Ex. 100-R, 101-R, 102-R)

120. In their complete responses to the aforementioned subpoenas, Peak, RocQuest, and ZW Enterprises provided only copies of cancelled checks written by Peak during 2010 and 2011. (Tr. 174)

121. No documents were produced by RocQuest and ZW Enterprises with respect to the insurance services performed by petitioner and third party insurance companies. (Entire Record)

B. Policies and Premiums

122. Policies issued by petitioner, such as the policy for pollution coverage, could have been written specifically for petitioner by Capstone or recycled from another Capstone captive client. (Tr. 765)

123. There is no evidence to show which of petitioner's coverages were written specifically for petitioner and which coverages were recycled from another Capstone captive client. (Entire record)

124. Coverages would have been selected as a result of having a known potential exposure. (Tr. 70)

125. Zumbaum and Weikel, as the directors of petitioner, had the authority to determine the premium amounts for petitioner. (Tr. 135-136; 377)

126. Zumbaum did not know how the premium amounts were determined for petitioner. (Tr. 162)

127. Snyder did not have any involvement in the policies selected or the determination of the premium amounts. (Tr. 62-63)

128. David Liptz ("Liptz") is an outside accountant retained by Capstone and was also one of petitioner's experts. (Tr. 525)

129. In examining petitioner's premiums, Liptz compared only petitioner's premium amounts to other Capstone entities and did not use third party premiums. (Tr. 541)

130. Zumbaum was aware that the premiums Peak paid to petitioner would reduce Peak's net profit by claiming a higher deduction for business insurance expenses and reducing its federal income tax liability. (Tr. 161-162)

131. Zumbaum only "scanned through" the policies for the coverage years at issue and did not review the policies in detail. (Tr. 166)

132. Zumbaum was under the impression that the 2008 policies had a "look-back" period, but never actually looked at the policies at the time to determine whether a "look-back" period existed. (Tr. 165)

133. There is no evidence of any losses suffered by Peak during the "look-back" period (January 1, 2005 to December 3, 2008) stated in any of the policies containing a "look-back" provision issued by petitioner for the taxable years at issue. (Entire record)

134. There is no documentation to show how the final premium amounts were determined for any of the policies for the taxable years at issue. (Ex. 136-R; Entire Record)

135. Petitioner had no actuarial work done regarding their policies during the years at issue. (Ex. 136-R; Entire Record)

136. Petitioner's expert, Michael Solomon ("Solomon"), is an actuary for The Actuarial Advantage. (Ex. 117-P)

137. The Actuarial Advantage is company which had been previously engaged by Capstone. (Tr. 469-470)

138. Solomon did not review the methodology used by petitioner or PoolRe for determining their premiums for the taxable years at issue. (Tr. 471)

139. Doherty testified that to the extent loss data is available, it would be used in computing premiums. (Tr. 250)

140. When loss history is available, it is fairly easy to arrive at a premium amount and classify premiums according to different circumstances and features of the policy holders. (Tr. 262)

141. Petitioner's historical loss data had no credibility because there were no claims or only low claim activity for the taxable years at issue. (Tr. 410)

142. There was insufficient loss data across Capstone's entire captive insurance program for all years in operation to be used in determining a premium. (Tr. 479-480)

143. When loss history is unavailable, an insurer has to rely on expert judgments, such as looking at related risks, to determine if a risk is more or less likely than a risk where the premium value is known. (Tr. 263)

144. When using techniques other than loss history to arrive at a premium, there is a bigger margin of error in the premiums. (Tr. 263)

145. In Doherty's opinion, without loss history, you cannot get an accurate estimate of the amount of risk reduction. (Tr. 251)

146. If there is no loss data available, an actuary can't be employed to arrive at a premium. (Tr. 272)

147. In the absence of loss data, other experts (such as underwriters, technicians, and scientists) would make judgments about the likelihood of events to arrive at a premium for a risk. (Tr. 272)

C. Capstone's Premium "Methodology"

148. Capstone uses no formal quantitative mathematically based methodology for determining insurance premiums, which deviates from insurance industry standards and practices. (Ex. 136-R)

149. Capstone claimed to use total revenue of an insured, number of employees of an insured, or property value to determine the basis for a premium. (Tr. 316)

150. Total revenue, or number of employees, was used as the starting point for Capstone's clients regardless of the insured's industry, insurance exposure risk, or specific needs for a particular line of coverage. (Tr. 316, 421)

151. The policy rate analysis from Capstone was used to determine new premiums. The policy rate analysis was created using only an averaging of premiums from Capstone's prior premium information. (Tr. 346; Ex. 110-P)

152. Capstone's rating system to create premiums for new policies was backed into using preexisting Capstone client premium information. (Tr. 351)

153. No Policy Rate Analysis Summary exists for the 2008 and 2009 years. (Entire record)

154. The 2010 Policy Rate Analysis Summary from Capstone does not correspond with the rate listed on petitioner's 2010 rating worksheet. (Exs. 110-P, 112-P)

155. There is no documentation in the record to support how Capstone generated the 2010 Policy Rate Analysis Summary, what data was used in compiling the 2010 Policy Rate Analysis Summary, or when it was created. (Entire Record)

156. Petitioner's rating worksheet premiums do not correspond with the premium amounts paid according to petitioner's insurance binders. (Exs. 59-J, 74-J, 35-J, 112-P)

157. McNeel was involved with setting petitioner's premiums for the taxable years at issue, but did not determine the actual premium amounts. (Tr. 323)

158. McNeel was not solely responsible for premium pricing as the process involved "lots of people providing input." (Tr. 637)

159. McNeel did not explain how he was involved, what work he performed, or the extent of the documentation he reviewed regarding petitioner's premiums for the taxable years at issue. (Entire record)

i. Mid-Continent General Agency, Inc.

160. Mid-Continent General Agency, Inc. ("Mid-Continent") prepared worksheets with indications for petitioner regarding insurance premiums for each of the taxable years at issue. (Tr. 336; Ex. 109-P)

161. An indication is a showing of what the price would be as compared to a quote, which is an offer of insurance coverage at a set price. (Tr. 343)

162. The premium amounts listed on the Mid-Continent indication sheets do not correspond with the premium amounts paid according to petitioner's insurance binders. (Exs. 59-J, 74-J, 35-J, 109-P)

163. The underlying documentation used in creating the indication sheets from Mid-Continent was not provided. (Entire Record)

164. No testimony from Mid-Continent or Janis Selph, the person identified on the indication sheets, was provided. (Entire Record)

165. Petitioner has not explained the analysis that Mid-Continent performed or conducted and has not provided any documents reviewed or relied upon by Mid-Continent in creating the indication sheets. (Ex. 94-J)

166. The letter prepared by Mid-Continent, dated April 28, 2009, does not discuss petitioner, does not identify the Mid-Continent employees involved in preparing the indication sheets, and does not discuss the underwriting process or methodology used in creating petitioner's indication sheets. (Ex. 94-J)

167. Capstone claimed to have used Mid-Continent's ratings, and to have compared them with Capstone's internal projections and opinions, to determine the premium amounts. (Tr. 344)

168. No documents of Capstone's internal projections or opinion papers were introduced that show petitioner's ultimate premium amounts for the policies at issue. (Entire Record)

169. Petitioner's expert, Esperanza Mead ("Mead"), is an actuary that has been engaged by Capstone since the end of 2015. (Tr. 424)

170. Mead did not review any information from Mid-Continent or petitioner. (Tr. 414-415)

ii. Affiliated Entities

171. The named insureds on each of the 2008 Contracts, 2009 Contracts, and 2010 Contracts with petitioner were identified as Peak, RocQuest, and ZW Enterprises ("Affiliated Entities"). (Stip. ¶ 55, 71, 79)

172. The contracts listed a single combined premium payment due to cover all three Affiliated Entities. (Stip. ¶ 55, 71, 79)

173. The Affiliated Entities did not pay separate allocated premiums to petitioner for the taxable years at issue. (Entire Record)

174. The Affiliated Entities did not have an agreement to show how the premium payments were to be allocated between them. (Entire Record)

D. Credit Reassurance Limited ("CreditRe")

175. Gary Fagg ("Fagg") is the owner of CreditRe. (Tr. 735)

176. CreditRe has no employees. (Tr. 439)

177. CreditRe has no knowledge of petitioner's formation or operation. (Tr. 453)

178. Attachment A to the Credit Insurance Coinsurance Contracts between PoolRe and petitioner identifies alleged vehicle service contracts. (Exs. 52-J, 72-J, 87-J)

179. The alleged vehicle service contracts were initially insured by Linden. (Tr. 462)

180. Linden ceded the entire portion of the alleged vehicle service contracts to Aria of Bermuda. (Tr. 461, 464)

181. Aria of Bermuda then ceded roughly 30 percent of the alleged vehicle service contracts it possessed to CreditRe. (Tr. 461)

182. CreditRe then ceded a 5 percent portion of the alleged vehicle service contracts it possessed to PoolRe, which would be roughly 1.5% of the total alleged vehicle service contracts. (Tr. 461)

183. PoolRe then ceded the 1.5% of the total alleged vehicle service contracts, initially insured by Linden, amongst the participants in its pool. (Tr. 461)

184. There are no copies of the alleged vehicle service contracts ceded to petitioner in the record. (Entire Record)

185. No due diligence was conducted by petitioner regarding the alleged vehicle service contracts. (Entire Record)

186. Fagg testified that the alleged vehicle service contracts would result in claims. (Tr. 462)

187. Petitioner did not pay any claims as a result of the alleged vehicle service contracts. (Entire Record)

E. PoolRe Reinsurance Corp.

188. PoolRe and Capstone have a close day-to-day working relationship. (Tr. 50)

189. PoolRe is comprised solely of Capstone created captive insurance companies. (Tr. 813)

190. PoolRe was a client of Capstone during the taxable years at issue. (Tr. 734)

191. The day-to-day operation and management of PoolRe is delegated to Capstone, including administrative and clerical operations. (Tr. 50, 734)

192. Capstone maintains all the books and records for PoolRe. (Tr. 577)

193. Stephen Friedman is the owner of PoolRe. (Tr. 51, 734)

194. Snyder is a director of PoolRe. (Tr. 48)

195. Snyder conducts his work for PoolRe while in the Capstone offices. (Tr. 49)

196. Capstone directs Snyder as to what documents to sign regarding the operation of PoolRe. (Tr. 50)

197. Snyder has no authorization to sign checks on behalf of PoolRe. (Tr. 50)

198. PoolRe has no employees in Anguilla. (Tr. 75)

199. PoolRe has no employees in the United States. (Tr. 75)

200. At one point during its operation, PoolRe was domiciled in the British Virgin Islands with Atlas acting as its management company. (Tr. 52)

201. PoolRe was ultimately re-domiciled in Anguilla and the management company changed from Atlas to CIMA. (Tr. 52)

202. According to the Quota Share agreement for 2008, there were 52 Capstone clients participating in the PoolRe pool, including petitioner, for 2008. (Ex. 52-J)

203. According to the Quota Share agreement for 2009, there were 53 Capstone clients participating in the PoolRe pool, including petitioner, for 2009. (Ex. 71-J)

204. According to the Quota Share agreement for 2010, there were 58 Capstone clients participating in the PoolRe pool, including petitioner, for 2010. (Ex. 86-J)

205. The PoolRe pool during the taxable years at issue contained a variety of single policies. (Tr. 253-255)

206. PoolRe bears no risk in the Capstone arrangement. (Tr. 274-275)

207. Under the terms of the second reinsurance arrangement, referred to as the Credit Coinsurance Reinsurance Program, petitioner would assume reinsurance contracts from PoolRe. (Exs. 52-J, 72-J, 87-J)

208. There is no evidence to show what due diligence, if any, was conducted by petitioner regarding the other members of the pool. (Entire record)

209. Doherty did not review the captives or their underlying risks in PoolRe when examining diversification of members in the PoolRe pool. (Tr. 274)

210. Doherty has never reviewed a program similar to Capstone's program, where the captive insurance companies and the reinsurance pool are all managed by the same entity. (Tr. 275-276, 278)

211. There is no evidence to show how reinsurance premiums were calculated. (Entire Record)

212. Petitioner did not pay any claims pursuant to its agreement with PoolRe during the taxable years at issue. (Tr. 275)

213. Due to the lack of loss history amongst all the PoolRe pool participants, Doherty was unable to show how much risk reduction is achieved for the participants in the Capstone program. (Tr. 250-251)

F. Petitioner's Financials and Records

214. Capstone maintained all records for petitioner. (Tr. 134)

215. No books and records were maintained in petitioner's domicile of Anguilla. (Tr. 574)

216. Zumbaum did not have any records in Idaho regarding petitioner's business in the Anguillan domicile. (Tr. 164)

217. Capstone did not have any authority over petitioner's accounts to make investment decisions, write checks, wire transfer authority, or otherwise withdraw funds. (Tr. 726)

218. Capstone received only copies of petitioner's bank statements to compile petitioner's general ledgers. (Tr. 726)

219. Petitioner's bank statements only shows four checks issued; three checks related to the claim made in 2009 by Peak and Check #1001 in the amount of $5,250.00. (Exs. 29-P, 31-J, 32-J, 33-J, 90-J)

220. Petitioner's bank statements do not show any withdrawals except for the closing of the AmericanWest Bank account near the end of 2009. (Exs. 31-J, 32-J, 33-J)

221. Petitioner failed to establish that it paid any reinsurance premiums to PoolRe. (Exs. 31-J, 32-J, 33-J; Entire Record)

222. Anguillan law required insurance companies to submit annual financial accounts audited by an independent auditor approved by the Anguilla Financial Services Commission. (Ex. 14-J)

223. For taxable years at issue, petitioner prepared unaudited financials. (Exs. 24-J, 25-J, 26-J)

224. On May 20, 2011, Liptz & Associates, Inc. prepared an Independent Auditor's Report for petitioner for the taxable years at issue. (Ex. 27-J)

225. Liptz & Associates, Inc. utilized petitioner's unaudited financial information prepared by Capstone. (Tr. 533)

226. The only step required by Liptz & Associates, Inc. to be approved by the Anguilla Financial Service Department to audit captive insurance companies domiciled in Anguilla was to submit a letter that discusses prior experience in auditing. (Tr. 590-591)

227. Feldman stated Capstone billed a fee of roughly $15,000.00 per quarter, or $60,000 annually, to petitioner for its services. (Tr. 761)

228. Any costs billed for Capstone's services were borne partly by petitioner and partly by the Affiliated Entities. (Tr. 762)

229. There is no record of any payment for services to Capstone from petitioner. (Exs. 31-J, 32-J, 33-J)

230. There is no record of any payment for services to Capstone from Peak, RocQuest, ZW Enterprises, or any other party affiliated with Zumbaum. (Exs. 99-R, 100-R, 101-R, 102-R)

231. In October 2009, Zumbaum opened a U.S. brokerage account on behalf of petitioner with D.A. Davidson & Co. ("Davidson") in Osburn, Idaho. (Ex. 33-J)

232. There is no evidence that petitioner conducted any due diligence in connection with the opening of the brokerage account with Davidson. (Entire Record)

233. There is no evidence that Zumbaum consulted with petitioner's resident manager, Atlas, Capstone, or Weikel regarding a business relationship with Davidson. (Entire Record)

G. Insurance Claim

234. Pursuant to the Settlement and Release Agreement executed on May 27, 2009, petitioner alleged that Peak reported a claim on April 6, 2009 for loss of net income related to the reduction of orders from one of Peak's customers, Stillwater Mining Company ("the 2009 Claim"). (Ex. 90-J)

235. The 2009 Claim was made under the policy that protected Peak against "loss of sales." (Tr. 138; Stip. ¶ 86)

236. In auditing petitioner, Liptz and Associates, Inc. did not conduct due diligence to verify the 2009 Claim. (Tr. 573)

237. Zumbaum, as the owner of petitioner and Peak, does not recall the procedures involved for submitting the 2009 Claim. (Tr. 138)

238. Zumbaum submitted the 2009 Claim to Capstone on April 6, 2009. (Tr. 138; Ex. 90-J)

239. Petitioner failed to document the 2009 Claim and failed to demonstrate whether any procedures were followed in

regards to how the 2009 Claim should be filed, reviewed, and paid. (Entire Record)

240. There is no evidence of any due diligence conducted by petitioner to determine whether Stillwater Mining Company met the definition of a major customer under the 2009 Contract for Special Risk - Loss of Customer. (Entire Record)

241. With respect to the 2009 Claim, petitioner agreed to pay $164,820 by check made payable to Peak through the agreement executed on May 27, 2009. (Ex. 90-J; Tr. 143)

242. On April 21, 2009, petitioner wrote a check made payable to Peak in the amount of $150,000. (Stip. ¶ 84; Ex. 89-J; Tr. 142)

243. The payment of the $150,000 on April 21, 2009, was made prior to the execution of the claim Settlement and Release Agreement on May 27, 2009. (Exs. 89-J, 90-J)

244. The claim Settlement and Release Agreement stated that the amount of $164,820 "shall be paid by Insurer through a check made payable to "Peak Mechanical & Components, Inc." (Ex. 90-J)

245. On June 27, 2009, petitioner wrote another check made payable to Peak in the amount of $14,820. (Ex. 91-J; Tr. 144)

246. On September 10, 2009, petitioner wrote an additional check made payable to Peak in the amount of $175,000 regarding the 2009 Claim. (Ex. 92-J; Tr. 144)

247. Jill Howard ("Howard") is the financial manager and office manager for Peak. (Tr. 121)

248. Howard signed the checks related to the 2009 Claim as amended on behalf of petitioner. (Exs. 89-J, 91-J, 92-J)

249. Howard held signatory authority over petitioner's U.S. checking account with American West Bank located in Osburn, Idaho. (Stip. ¶ 91)

250. Howard is not an employee of petitioner. (Tr. 153)

251. On January 1, 2012, petitioner and Peak amended the May 27, 2009 Settlement and Release Agreement whereby petitioner agreed to pay Peak an additional $175,000. (Ex. 93-J)

VII. Petitioner's Experts are Not Credible

252. Kinion only has experience with approximately 10 Anguillan captive insurance entities. (Tr. 212)

253. Kinion gave no opinion regarding premium analysis or premium computation for petitioner. (Tr. 216)

254. Kinion was compensated for his time as an expert by Feldman Law Firm. (Tr. 226)

255. Doherty was compensated for his time as an expert by Feldman Law Firm. (Tr. 239)

256. Doherty has previously consulted with Capstone regarding its insurance structure. (Tr. 240)

257. Mead relied on aggregate data of all Capstone captive insurance companies for the years 2011 through 2015. (Tr. 411)

258. No Capstone data from 2008 to 2010 was used in compiling Mead's report. (Tr. 412)

259. Mead did not review any information from Mid-Continent or petitioner. (Tr. 414-415)

260. Mead was compensated for her expert testimony and report by Feldman Law Firm. (Tr. 423)

261. Mead has been engaged by Capstone since the end of 2015 to present. (Tr. 424)

262. Solomon did not review the methodology used by petitioner or PoolRe for determining their premiums for the taxable years at issue. (Tr. 471)

263. Solomon relied on the data provided by Capstone without audit or verification. (Tr. 477)

ULTIMATE FINDINGS OF FACT

264. Petitioner's insurance and reinsurance transactions with regard to the payment of premiums had no significant and no legitimate non-tax purpose, and, therefore, lacked economic substance. (Entire Record)

265. The amounts paid by Peak, an Idaho based entity, to petitioner, an Anguillan entity, were not paid for insurance and are subject to a withholding tax under section 881(a)(1). (Entire Record)

266. The Feasibility Study shows the mechanical operation of how Capstone enabled and established the tax avoidance vehicle through which the purported insurance policies moved monies from Peak to petitioner for tax-motivated purposes. (Entire Record)

267. Petitioner has not demonstrated that Peak, RocQuest, and ZW Enterprises were exposed to the types of risks the contracts purported to cover. (Entire Record)

268. Petitioner did not shift risk to unrelated parties through PoolRe. (Entire Record)

269. Petitioner did not shift risk through the CreditRe arrangement. (Entire Record)

270. Petitioner did not have risk distribution. (Entire Record)

271. Petitioner is not an insurance company for federal tax purposes. (Entire Record)

272. Petitioner does not qualify as a tax-exempt entity described in section 501(c)(15). (Entire Record)

273. Petitioner was not eligible to make an election under section 953(d). (Entire Record)

274. Petitioner is required to file Forms 1120-F to report gross income of $481,792, $548,059, and $561,017 for the taxable years 2008, 2009 and 2010, respectively. (Entire Record)

275. Petitioner is subject to the 30 percent tax imposed by section 881(a) in the amounts of $144,538, $164,418 and $168,305 for the taxable years 2008, 2009 and 2010, respectively. (Entire Record)

POINTS RELIED UPON

Petitioner's creation and existence is not rooted in any economic reality. Petitioner did not exist to supplement or replace Peak's commercial third party insurance coverage, or to permit any insurance arrangement at all. Instead, petitioner was created, under Capstone's blueprint, as a vehicle to move money offshore while attempting to capture the tax benefits derived from excessive, unnecessary, and unsubstantiated "insurance" expense.

The entire arrangement was controlled by Zumbaum and Weikel, the sole shareholders and officers of Peak and the indirect shareholders and directors of petitioner. With the assistance of Capstone and Feldman Law Firm, Zumbaum and Weikel created a purported captive insurance arrangement to reduce Peak's taxable income by claiming deductions for purported insurance premiums paid to petitioner. At the same time, petitioner treated receipt of those premiums as exempt from U.S. taxation under section 501(a) because petitioner claimed to be described in section 501(c)(15). The premiums at issue totaled $412,089, $448,127, and $445,314 for the taxable years 2008, 2009 and 2010, respectively.

First, petitioner's purported captive insurance arrangement served no legitimate nontax purpose and lacks economic substance. After the creation of petitioner, Peak and its

affiliated entities, through Zumbaum and Weikel, did not change the pre-existing third party insurance policies or insurers. During the taxable years at issue, Peak maintained comprehensive insurance coverage with commercial third party insurers.

Further, there is no evidence that Peak conducted any due diligence, beyond the Feasibility Study drafted by Capstone, to support the need for petitioner or the excess insurance contracts it issued. Peak made no attempt to go into the open insurance market to determine if third party coverage was available, or its potential cost, for the alleged insurance risks involved.

Equally, petitioner failed to establish the need of RocQuest and ZW Enterprises for the excess insurance contracts. Petitioner cannot show the portion, if any, of the purported premiums paid by Peak to petitioner that was allocable to RocQuest and ZW Enterprises. Instead, there is no evidence of the premium portion attributable to RocQuest and ZW Enterprises.

Petitioner cannot show how the final premium numbers were calculated for any of the excess insurance contracts. The "indication sheets" do not reflect the final premium numbers. Petitioner had no loss data or loss history to base the premium calculation on. Without loss data, a premium calculation is far less reliable. Nonetheless, petitioner did not even follow the methods to compute a premium described by petitioner's experts.

Notably, the lack of economic reality of the premiums charged by petitioner is demonstrated by the fact that petitioner charged approximately the same premium for less than one month of coverage in December 2008 as it did for each of the calendar years 2009 and 2010. Further, there is no evidence to show how reinsurance premiums allegedly paid by petitioner to PoolRe were calculated and whether such purported reinsurance premiums were actually paid.

Second, petitioner's captive insurance arrangement does not qualify as insurance for federal income tax purposes, and consequently, petitioner was not an "insurance company" eligible to exclude premium income under section 501(a) as an organization described in section 501(c)(15). There is no evidence of any underwriting, mathematical calculations, actuarial opinions, or evaluations of risks to establish the rates of premiums for petitioner's policies at issue in this case. There is no documentation to support the reinsurance premiums paid from pool participants to petitioner through PoolRe's reinsurance programs. Petitioner cannot demonstrate that premiums paid by Peak, or those allegedly paid to PoolRe, were actuarially determined or calculated in a manner that could compensate for unexpectedly large losses. Importantly, there is no evidence that the reinsurance premiums were actually paid.

Further, petitioner did not distribute risk. There is no evidence of the risks distributed among PoolRe's reinsurance programs. Moreover, Peak, RocQuest, and ZW Enterprises did not shift risk to petitioner as neither petitioner's premiums nor petitioner's capital were established in a manner to account for contingent historical losses or unexpected future losses.

Petitioner's captive insurance arrangement also does not involve the existence of a legitimate insurance interest. There is no evidence to support Peak's need for the excess policies. Peak maintained comprehensive third party commercial insurance coverage. Peak's risk was truly being insured in those third party commercial coverages and, as a result, Peak had no exposure to the types of risks the contracts with petitioner purported to cover.

Petitioner's experts are not credible. Several testified as both fact and expert witnesses, or were involved in the transaction, tainting their impartiality and displaying a bias towards petitioner. For example, Snyder was the signatory on the Feasibility Study, Fagg was the owner of CreditRe who participated in the structure, and Liptz was the financial auditor for petitioner. The majority of the experts were also paid by either Capstone or Feldman Law Firm, both of which are heavily invested in the success of the transaction. Mead and Solomon have been engaged by Capstone for several years and

their methods rely exclusively on Capstone produced data, creating a circular reasoning in an attempt to justify petitioner's premiums well after the fact. The bulk of the data reviewed by the various experts was provided and selected by Capstone.

Petitioner bears the burden of proof in this case and has failed to establish that its captive insurance arrangement had economic substance and that its captive insurance arrangement qualifies as insurance for federal income tax purposes. Instead, petitioner was formed and operated by Zumbaum and Weikel, with the assistance of Capstone, to shelter Peak's profits in a tax-free manner. Peak moved hundreds of thousands of dollars offshore to petitioner, an Anguillan entity. For the reasons set forth herein, the payments from Peak to petitioner during the taxable years at issue did not qualify as tax-exempt insurance premiums, but rather constituted taxable income to petitioner subject to thirty percent withholding tax under section 881(a)(1).

ARGUMENT

Petitioner was not created for the purpose of insuring the risks of Zumbaum's and Weikel's businesses, but rather it was created for the purpose of sheltering tax-free money. When Capstone came to visit in August 2008, Zumbaum and Weikel had already made up their mind that they were going to form petitioner. Before the Feasibility Study was even finalized in August 2009, petitioner had been in operation and collected two full years' worth of premiums. In fact, in less than four months from a mere site visit, petitioner was created, policies were issued for December 2008, and a full year's worth of premiums were paid -- even though only three weeks remained before the 2008 taxable year ended.

The premiums involved for the taxable years at issue were not calculated by actuaries, underwriters, or insurance experts, but were decided arbitrarily by two business owners, in conjunction with Capstone, looking to maximize Peak's tax benefits. Nothing in the loss history detailed by Zumbaum was covered by the policies written by Capstone for petitioner. The alleged "risks" involved were not based on an economic reality beyond tax benefits.

The only risk involved for Zumbaum and Weikel was whether or not petitioner's returns would be audited and the proper amount of tax collected. The evidence shows that petitioner was

not operating as an insurance company, but rather as a complex tax-motivated vehicle that Capstone attempts to masquerade as a legitimate insurance company through a captive arrangement.

Before considering whether an arrangement constitutes insurance, courts first consider whether the purported insurance company was legitimate. Rent-A-Center, 142 T.C. 1, 11 (2014). However, a finding of sham is not a necessary condition for finding that an arrangement does not constitute insurance for Federal tax purposes. Malone & Hyde, Inc. v. Commissioner, 64 F.3d 835, 842 (6th Cir. 1995), rev'g T.C. Memo. 1993-385. A captive arrangement is a sham where there is no legitimate business purpose for establishing the captive. See Rent-A-Center, 142 T.C. at 11; Clougherty Packing Co. v. Commissioner, 84 T.C. 948, aff'd, 811 F.2d 1297, 1300 (9th Cir. 1987). As the evidence shows, this case is inapposite to Rent-A-Center for several reasons: petitioner was not formed to reduce costs, provided no accountability, and lacked transparency; the insurance arrangement created nothing more than a system of money shuffling back and forth in the form of premiums and claims with no economic reality to support them; and petitioner was not adequately capitalized. Therefore, petitioner's arrangement does not constitute insurance.

I. Petitioner Bears the Burden of Proof

Respondent's notice of deficiency is presumed correct and the burden of proof is on petitioner to show that the determinations made therein are erroneous. T.C. Rule 142(a); Welch v. Helvering, 290 U.S. 111, 115 (1933). In this case, petitioner carries the burden of proving that it is described in section 501(c)(15), including whether the contracts and premiums at issue have economic substance and whether petitioner is a genuine insurance company.

II. Petitioner's Purported Insurance And Reinsurance Arrangements Lack Economic Substance

Respondent's adjustments in the Notice of Deficiency should be sustained in full under the judicial doctrine of economic substance.[3] The purported premium payments made by Peak to petitioner for the alleged captive insurance coverages had no economic substance beyond tax benefits. Further, Peak, RocQuest, and ZW Enterprises have failed to demonstrate a non-tax business purpose for entering into the captive insurance arrangement for the purported insurance and/or reinsurance transactions at issue in this case.

The Courts have long recognized that people will devise sophisticated ways to avoid taxes and that "[e]ven the smartest drafters of legislation and regulation cannot be expected to

[3] Respondent is not asserting the codified version of the economic substance doctrine set forth at I.R.C. § 7701(o).

anticipate every device." ASA Investerings Partnerships v. Commissioner, 201 F.3d 505, 513 (D.C. Cir. 2000), cert. denied, 531 U.S. 871 (2000). To discourage the "essentially wasteful activity" of designing tax avoidance transactions, courts have applied the "economic substance" doctrine. Id.

Under the economic substance doctrine, transactions that lack business purpose and economic substance other than mere tax avoidance do not properly avoid Federal income tax. Frank Lyon Co. v. United States, 435 U.S. 561, 573 (1978). Using the economic substance doctrine, courts may disregard transactions that "comply with the literal terms of the tax code but lack economic reality." Coltec Industries, Inc. v. United States, 454 F.3d 1340, 1352 (Fed. Cir. 2006); see also New Phoenix Sunrise Corp. v. Commissioner, 132 T.C. 161, 174-176 (2009); Palm Canyon X Invs., LLC v. Commissioner, T.C. Memo. 2009-288. The economic substance doctrine applies to prevent taxpayers from subverting the legislative purpose of the tax code by engaging in transactions that are fictitious or lack economic reality simply to reap a tax benefit.

In Rent-A-Center, Inc. v. Commissioner, 142 T.C. 1 (2014), the Court addressed the issue of whether members of an affiliated group of U.S. corporations filing consolidated returns may claim deductions for payments made to a foreign captive insurer wholly owned by the common parent. The Court

held that they may. The Rent-A-Center Court determined, in part, that, (1) the captive was formed to reduce insurance costs, formalize and more efficiently manage the insurance program, and provide accountability and transparency; (2) there was no impermissible circular flow of funds among the brother-sister corporations and nothing unusual concerning "the manner in which premiums and claims were being paid"; and (3) the captive was adequately capitalized. Id. at 11-12.

A. The Creation Of Petitioner Did Not Replace The Insureds' Existing Third-Party Insurance Coverages And Instead Resulted In Excessive Insurance Expenses Solely For A Tax Benefit Purpose Without Economic Reality

In this case, the evidence shows that Peak was significantly increasing its total insurance costs for tax benefit purposes without increasing actual risk coverage. Peak continued to maintain comprehensive insurance coverage with EMC, Idaho State Insurance Fund, and Ace American Insurance Company despite Zumbaum's apparent displeasure after EMC investigated his claim regarding the snowfall accumulation on the roof. Zumbaum experienced subpar service from EMC, which allegedly inspired the creation of petitioner. Nonetheless, Zumbaum *continued his coverage with EMC with the same policies in place* for the taxable years at issue.

Prior to the formation of petitioner, Peak incurred insurance expenses for insurance premiums in the amounts of

$38,810, $95,828, and approximately $40,000 for each of the taxable years 2006, 2007, and 2008, respectively. After the formation of petitioner, Peak's insurance premiums increased by $412,089, $448,127 and $445,314 as a result of the excess direct written insurance contracts with petitioner for each of the taxable years 2008, 2009, and 2010, respectively. These amounts were in addition to the insurance coverage that Peak maintained with EMC, Idaho State Insurance Fund, and Ace American Insurance Company during the taxable years at issue.

Even though Zumbaum and Weikel were, on the surface, running their own insurance company to have better control over their claims, they did not replace any of their existing policies and insured areas with coverages provided through petitioner. Moreover, commercial auto insurance was discussed briefly in the Feasibility Study, but no coverage was put in place through petitioner despite the reported losses in that area by Peak. For the only other loss that Peak experienced relating to weather-related business interruption coverage, Peak instead opted to put a policy in place to cover such a loss event for less than *one month*. Without explanation, coverage for weather-related business interruption was dropped when petitioner issued new policies for 2009.

The fact that Peak's legitimate insurance coverage continued to remain with third-party insurers shows that the

coverages written by petitioner were nothing more than a means to create a tax benefit for Peak. Further, if Peak was truly attempting to cover the sort of catastrophic loss suffered by an unrelated company, to which Zumbaum testified, there is no indication in the Feasibility Study regarding the coverage amounts that should be employed. By Zumbaum's own testimony, the amount involved in the specific case referenced would have surpassed any of the individual coverages in place. Petitioner did not cover the areas where Peak had actual losses and exposure, but instead focused only on fictitious areas of "risk" in an attempt to justify premium amounts without economic reality.

B. Petitioner's Insurance Premiums Were Used Solely To Create Deductions For Peak And Divert Funds Offshore To An Entity Controlled By Zumbaum And Weikel

Through the captive insurance arrangement promoted by Capstone, Zumbaum and Weikel were able to transfer funds from Peak to petitioner as purported premiums for excess insurance coverage. One day after petitioner was formed, Zumbaum and Weikel issued 13 direct written contracts on December 4, 2008 as excess policies with petitioner. (RPFFs 68, 110) Even though the policies were for coverage running through only the remainder of December, Zumbaum and Weikel paid premium amounts equal to an entire year of coverage. (RPFFs 69, 81, 101) Although petitioner argues that the 2008 policies had a "look-

back" provision, it is not discussed in their premium pricing methodology as to how the "look-back" would impact the final premium amount and, further, is not covered by the Feasibility Study. In fact, the Feasibility Study does not discuss "look-back" provisions or retroactive policies at all, and there is no documentation to support the premium amounts for policies written with such a provision. (Ex. 16-J; RPFF 133)

Zumbaum, as the person most knowledgeable about any potential claims that could have been filed for 2008 and prior years, did not even bother to examine the policies to see if such a "look-back" provision existed. (RPFF 131, 132) The record shows that Peak, RocQuest, and ZW Enterprises had no prior year losses beyond the snowy roof and auto claims. (RPFFs 25, 26, 33, 133) Nevertheless, Zumbaum paid excessive premium amounts for less than a month of coverage in order to have a "look-back" provision, which he didn't know existed for losses that he testified did not occur in prior years.

Looking at the 2008 Contracts, six out of the thirteen policies do not even *have* a "look-back" provision, but Zumbaum still paid the full price for these policies. (RPFFs 71-76) Interestingly, the policy for "Weather Related Business Interruption" lacks the "look-back" provision. (RPFF 74) If it had, Peak may have had a claim for the snow damaged roof in early 2008. Such an oversight does not reflect the economic

reality of a business looking to insure against risk and loss exposure. But instead, the insertion of the "look-back" provision indicates an attempt to generate the largest possible tax benefit before the end of the 2008 tax year.

In 2009 and 2010, Peak, RocQuest, and ZW Enterprises executed 11 direct written contracts with petitioner as excess policies for each year. (RPFFs 80, 100) The insured parties for the 2008 Contracts, 2009 Contracts, and 2010 Contracts were identified as Peak, RocQuest, and ZW Enterprises. (RPFF 171) Zumbaum and Weikel after setting up petitioner in December 2008 were able to access petitioner's funds through the questionable 2009 Claim that allowed for the amounts paid to petitioner to return to Peak's bank account. The only evidence presented at trial, besides self-serve testimony, regarding Peak's claim for the loss of a major customer was a single document that was void of any detail as to whether or not Stillwater Mining Company met the requirements of a "major customer" under the 2009 policy. (RPFF 239, 240) Further, before the loss was paid, no due diligence was conducted by petitioner or Capstone in order to verify whether or not the loss of Stillwater Mining Company as a customer actually decreased Peak's sales.

Regarding the 2009 Claim, the facts also show $150,000 was paid out to Peak from petitioner before the Settlement and Release Agreement was even executed. (RPFF 241, 242, 243)

Further, an additional check for $175,000 was paid to Peak from petitioner, allegedly for the same claim on September 10, 2009. (RPFF 246) Only on January 1, 2012, *over two years later*, did petitioner and Peak amend the May 27, 2009, Settlement and Release Agreement to account for this additional payment. (RPFF 251) A real insurance company would not pay a claim without due diligence and without a release agreement in place prior to payment. The money simply flowed from petitioner's account controlled by Zumbaum and Weikel back to their own pockets through Peak. Howard, who has been identified as only affiliated with Peak and not with petitioner, executed the checks from petitioner's bank account in Idaho. (RPFFs 247-250) The petitioner was not acting like an insurance company, but rather like another checking account for Peak.

Unlike Rent-A-Center, wherein the Tax Court found an extensive feasibility study that included a determination of what would constitute adequate capitalization, Id. at 4, such determinations did not occur in this case for the insured parties. Capstone only conducted the Feasibility Study for Peak which was finalized in August 2009 about one year after the initial site visit on August 13, 2008 and about nine months after two years' worth of policies were issued by petitioner. There was no documentation as to why Zumbaum and Weikel executed 13 excess policies with petitioner for one month only in

December 2008, given that Peak had no history of any significant losses beyond the snow accumulation on the roof or the auto claims that were apparently covered by Peak's existing insurance company. Further, while the premiums for the insurance coverage of the 2008 Contracts totaled $412,089 for less than a month, the annual premiums for insurance coverage of the 2009 Contracts and 2010 Contracts totaled $448,127 and $445,314, respectively. (RPFFs 69, 81, 101) Petitioner has failed to provide an explanation as to why the premiums charged for less than one month of coverage in 2008 approximated the premiums charged for a full year of coverage for each of the years 2009 and 2010.

Finally, petitioner provided no documentation concerning the business operations of RocQuest and ZW Enterprises and the need for additional insurance for these entities. Petitioner made no separate allocations of premiums for RocQuest or ZW Enterprises, and no premiums were paid by RocQuest or ZW Enterprises. Based on the record, it appears that Peak paid for the purported additional insurance for RocQuest and ZW Enterprises.

C. Petitioner's Insurance Premiums Are Not Supported By A Credible Methodology And There Is No Documentation To Support The Final Premium Amount

A significant question is how premium amounts can and should be calculated. It was not disputed by petitioner's experts that the use of historical loss data is the most

accurate way to determine a premium amount. In the absence of historical loss data other methods can be used to compute a premium, but the computation will be less accurate. As petitioner's experts opined, these other methods include looking at comparable loss data within the industry. For example, in creating a premium regarding Porches' warranty program, one could look at Hyundai's warranty program and use the loss data present there as a comparable set of data. This data would be combined with an underwriter's knowledge and experience to compute a premium value for a policy. (RPFFs 143, 147) Regardless of the method employed, all methods use historical loss data in one form or another as historical loss is the best indicator of future losses. (RPFF 139, 140)

Petitioner has failed to provide any such underwriting, mathematical calculations, actuarial opinions, or evaluations of risks to establish rates of premiums for petitioner's policies at issue in this case at the time the policies were created. Looking at the minimal documentation actually provided, nothing presented by petitioner accurately supports or directly corresponds with the final premium amounts charged for the policies. Rather the evidence shows that petitioner was created to take advantage of section 501(c)(15) by establishing an off-shore entity in a country with minimal regulatory compliance in order to maximize premiums and in turn, maximize tax benefits.

i. Mid-Continent's Indication Sheets Cannot Be Considered Reliable As They Are Inaccurate And Unsupported By Underlying Documentation

The indication sheets prepared by Mid-Continent for petitioner are unreliable. No testimony was provided by Mid-Continent as to what methodology was used to create the premium estimates set forth on the indication sheets. The indication sheets contain several assumptions such as assuming that there is "no underlying coverage for these policies unless express noted in these indications." (Ex. 109-P) Looking at the indication sheets, the first policy listed for all years is "Excess Cyber Risk." (Ex. 109-P) Petitioner did not have a cyber risk policy on its existing coverage, yet Mid-Continent computed a premium assuming an underlying coverage. Further, several of the policies in petitioner's insurance binder are for excess policies such as pollution and intellectual property. (RPFFs 70, 82, 102) Mid-Continent's indication sheets do not show that the policies are excess, but give a premium estimate regardless. (Ex. 109-P)

Another major assumption of Mid-Continent's indication sheets are that the indications are "based on the data presented and reviewed at the time." The numbers contained on the indication sheets are also "valid for one week from the date of presentation." (Ex. 109-P) No evidence has been presented as to what data was presented to Mid-Continent or what was reviewed

in preparing the indication sheets. The indication sheets are undated and no evidence was presented as to when the documents were provided to petitioner or Capstone. Accordingly, there is no evidence that the indication sheets were prepared or presented to petitioner contemporaneously. These indication sheets could have been prepared after the policies were in place and the premium checks written.

Lastly, the indication sheets do not contain all the policies written by petitioner. There is no indication number for the "Legal Expense Reimbursement" policy that was written by petitioner for the 2009 and 2010 tax years. For the remaining policies written by petitioner, the final premium amount charged for each policy does not correspond with the indication for each policy as prepared by Mid-Continent. (RPFF 162)

ii. Capstone's Internal Data Is Unreliable As It Consists Of Circular Reasoning and Reliance Upon Other Capstone Internal Data

Capstone's internal data regarding how premiums are priced is sparse and what little documentation that does exist fails to show how petitioner's premiums were computed in a reliable way. First, Capstone provided a document entitled "2010 Policy Rate Analysis Summary." (Ex. 110-P) This document is not a methodology for how premiums should be calculated. Rather, the 2010 Policy Rate Analysis Summary is an *averaging* of all existing policies from all of Capstone's existing clients as is

apparent from the titles on the columns such as "Overall Base Rate Average," "Base Rate Average," "Base Rate Range," "IRPM Average," and "IRPM Range." (RPFF 151) Nothing in the 2010 Policy Rate Analysis Summary indicates that it was used for underwriting policies or establishing premium amounts, but rather the 2010 Policy Rate Analysis Summary consisted of an internal analysis of the policies previously issued by Capstone captive clients to determine averages. (RPFF 151)

Further, the 2010 Policy Rate Analysis Summary is not specific to petitioner as it lists numerous policies not issued by petitioner for any of the taxable years at issue and contains policies not even addressed in the Feasibility Study. (Ex. 110-P) Much like Mead's report, the 2010 Policy Rate Analysis Summary simply starts with the assumption that all the premiums, regardless of a particular industry or specific risk exposures that may be present, are universal for all of Capstone's clients. Petitioner, through Capstone, is attempting to justify premium amounts without specific solid documentation or data that bear any relation to petitioner. The 2010 Policy Rate Analysis Summary is not a premium pricing sheet, but rather a pricing sheet for the tax benefits petitioner would enjoy for the 2010 tax year.

Lastly, the Rating Worksheets prepared by Capstone are unreliable as well. Nothing in the Rating Worksheets indicates

when they were made, what data was used in determining the rates, how the pro rata percentages were determined, or how the individual risk premium modification ("IRPM") number was computed. Looking at the Rating Worksheets, there is no explanation as to how the "Premium" column is computed, but rather a number is just generated out of thin air. No other evidence in the record shows how the "Premium" column is computed. (RPFF 155, 156) Regardless of how the premiums are computed on the Rating Worksheets, another glaring weakness in their unreliability is that the premium numbers do not match the final premiums charged by petitioner according to the insurance binders. (RPFF 156)

D. Petitioner's Lack Of Documentation To Support The Insurance Arrangement Further Shows Petitioner Was Created For The Sole Purpose Of Reducing Peak's Tax Burden

Zumbaum stated he created petitioner in order to have a greater degree of control over his insurance and to have better service on claims. It is clear from the record that the service on his claims was performed by the same person making the claims - ultimately himself. While there is a *de minimis* amount of documentation, the documentation provides only a thin façade to hide the true motive of petitioner. As for the lack of evidence produced by petitioner, it is settled law that petitioner's failure to produce evidence solely within his possession and

control, which, if true, would be favorable to him, gives rise to the presumption that if produced the evidence would be unfavorable. Wichita Terminal Elevator Co. v. Commissioner, 6. T.C. 1158 (1946), aff'd, 162 F.2d 513 (C.A. 10, 1947); Shaw v. Commissioner of Internal Revenue, 27 T.C. 561, 573 (1956), aff'd, 252 F.2d 681 (6th Cir. 1958); Glimco v. Commissioner, 397 F.2d 537, 540-541 (7th Cir. 1968), aff'g a Memorandum Opinion of this Court, cert. denied, 393 U.S. 981 (1968).

Looking at the insurance policies themselves, they appear to be cookie-cutter policies produced by Capstone for its clients. For example, the 2008 directors and officer's liability policy attachment listing the individuals covered by the policy is blank. (RPFF 93) In addition to this complete omission rendering the policy void, the 2008 policies for tax liability and regulatory changes for petitioner are for the insured entities PAE and PAP. (RPFF 95, 98) Beyond their names on the petitioner's insurance policy, there is no indication of what these entities are, what their line of business is, and what due diligence petitioner did before insuring the entities. If the policies were issued with the incorrectly listed insureds then Peak, ZW Enterprises, and RocQuest were left without coverage and exposed to the risks purportedly covered by those particular policies. Further, the policies were incorporated into petitioner's Form 1024 submitted on August 31, 2009 which

was reviewed, signed, and purported as accurate under penalty of perjury by Zumbaum. (RPFF 89, 90) As the cover letter signed by Zumbaum clearly states, "Exhibit E3" contains "Copies of 2008 Insurance Policies issued by [petitioner]." The fact that these policies were issued by petitioner in 2008, as attested to by Zumbaum, with such critical defects as to render them useless for Peak, RocQuest, and ZW Enterprises further highlights that the main concern for Peak was to ensure a large tax deduction and not to cover any alleged risk exposures.

In fact, the majority of documentation petitioner provided in attempting to carry its burden was the insurance policies themselves. No other contemporaneous documentation was produced, such as the work an underwriter would have performed in creating the policies, correspondence with Capstone regarding the policy renewals, checks or wire transfer notifications for paying reinsurance premiums, documentation to describe the changes in premium amounts from year to year, documentation to describe the cancellation of certain policies only after one month, or any documentation to describe the need for new policies after only one month of petitioner's operations. Further, there is no engagement letter, invoices for services provided, or any other contract that would describe the services to be provided between petitioner and Capstone. The same void of documentation exists between petitioner and CIMA. Meanwhile,

when a third party outside of the Capstone structure was involved, Atlas, there are clear examples of service contracts, invoices, and correspondence to detail why certain decisions were being undertaken and compensated by petitioner. (Ex. 118-R; RPFFs 105, 106)

No such documentation exists when it pertains solely to petitioner. The void of documentation extends beyond petitioner to Peak, RocQuest, and ZW Enterprises as shown through their responses to the subpoenas issued by respondent. (RPFFs 118, 119, 120) Nothing exists beyond the sparse documentation in the record to support how petitioner conducted its business and for what purpose that business was conducted. Petitioner is asking the Court to take its operations at face value, to ignore how petitioner conducted itself, and to ignore that the computation of the premium amounts at issue lack any credible support. The evidence does not support the operations of a *bona fide* insurance business, and no documentation exists that is typically found within such a business.

Petitioner's premiums were not set by petitioner or determined using any reliable method for the purposes of writing insurance coverage, but were merely agreed to by Zumbaum and Weikel after they were proposed by Capstone in order to shelter the profits of Peak in a tax beneficial arrangement set up by Capstone. Petitioner's captive insurance arrangement was

undertaken by Zumbaum and Weikel for Peak for the sole purpose of avoiding federal income tax. Accordingly, petitioner's purported insurance and reinsurance arrangements lack economic substance.

III. Petitioner's Captive Insurance Arrangement Does Not Qualify As Insurance For Federal Income Tax Purposes, And Consequently, Petitioner Was Not Exempt From Taxation Under Section 501(a) As An "Insurance Company" Described In Section 501(c)(15)

Neither the Code nor Treasury regulations define "insurance." Securitas Holdings v. Commissioner, T.C. Memo. 2014-225, at *18. Courts have held, however, that a captive insurance arrangement among affiliates can constitute insurance for federal income tax purposes where the arrangement satisfies the following elements: (1) the arrangement is "insurance" in its commonly accepted sense; (2) there is risk distribution; (3) there is risk shifting; and (4) the arrangement involves the existence of "insurance risk." Rent-A-Center, Inc. v. Commissioner, 142 T.C. 1, 21 (2014); Sears, Roebuck & Co. v. Commissioner, 96 T.C. 61, 101 (1991), aff'd in part and rev'd in part, 972 F.2d 858 (7th Cir. 1992); AMERCO, Inc. & Subs. v. Commissioner, 96 T.C. 18, 38 (1991), aff'd, 979 F.2d 162 (9th Cir. 1992); Harper Grp. v. Commissioner, 96 T.C. 45, 58 (1991), aff'd, 979 F.2d 1341 (9th Cir. 1992). Courts consider "all of the facts and circumstances to determine whether an arrangement qualifies as insurance." Rent-A-Center, 142 T.C. at 22 (citing

Harper Grp., 96 T.C. at 57).

A. Petitioner's Captive Insurance Arrangement Is Not Insurance in the Commonly Accepted Sense

The determination of whether an arrangement fits within the "commonly accepted sense" of insurance is based on all the surrounding facts and circumstances of the arrangement, with emphasis on comparing the implementation of the arrangement with that of known insurance. Several cases have weighed certain nonexclusive factors in determining whether an arrangement fits within the "commonly accepted sense" of insurance. These nonexclusive factors include whether: (1) the insurer is organized, operated, and regulated as an insurance company by the States in which it does business; (2) prices premiums at arm's length; (3) those premiums are reasonable in relation to the risk of loss; (4) the insurer entered into valid and binding insurance contracts; and (5) the insurer is adequately capitalized. See, e.g., R.V.I. Guaranty Co., Ltd. & Subsidiaries v. Commissioner, 145 T.C. 209 (2015); Securitas Holdings, Inc. v. Commissioner, T.C. Memo. 2014-225, at *27; Harper Group, 96 T.C. at 60.

Petitioner was not offering insurance in the commonly accepted sense. While petitioner purportedly followed certain corporate formalities, its operating practices were inconsistent with a bona-fide insurance arrangement.

Petitioner's premiums were not determined at arm's length and were not reasonable in relation to the risk of loss. There is no evidence of any underwriting, mathematical calculations, actuarial opinions, or evaluations of risks to establish the rates of premiums for the petitioner's policies at issue in this case. Consequently, petitioner cannot demonstrate that any single premium paid by Peak and/or paid to PoolRe was actuarially-determined or determined in a manner that could compensate for unexpectedly large losses.

Petitioner did not enter into *bona fide* insurance contracts. Zumbaum and Weikel, on behalf of Peak, executed contracts with themselves, on behalf of petitioner, and there is no evidence of any arm's length negotiations or due diligence conducted by the parties. The lack of *bona fide* insurance contracts is further evidenced by the fact that petitioner and PoolRe provided insurance for only one month in December 2008 and yet charged a full year's premium. (RPFFs 69, 81, 101) No credible or reliable evidence was presented to explain why this amount was charged, whether it reflects a standard rate within the insurance industry, and how the final amounts of premiums charged reflect market conditions to justify such a price. (RPFFs 134, 135, 141, 156, 159) Further, there was no feasibility study or other evidence as to why RocQuest and ZW Enterprises needed excess insurance with petitioner. Also,

RocQuest and ZW Enterprises did not pay premiums on any of the policies at issue in the case. The purported premiums were all paid by Peak, at the direction of Zumbaum and Weikel, to petitioner to reduce Peak's profits through the captive insurance arrangement set up by Capstone.

Petitioner was capitalized with $100,000 on December 10, 2008. (RPFF 111) Petitioner executed 13 direct written contracts in 2008 with an aggregate limit of $1,000,000 on each policy on December 4, 2008. The result is an exposure of potentially $13 million with only initial capitalization of $100,000 and the $412,089 paid in premiums to cover any loss. All it would have taken was a claim of $512,090, a foreseeable amount, to render petitioner insolvent. A similar situation exists in 2009 and 2010, with petitioner's exposure at potentially $11 million. Accordingly, petitioner was not adequately capitalized during the taxable years at issue.

Further, there is no evidence that petitioner had any employees, independent officers, or independent directors, leaving just Zumbaum and Weikel to provide the alleged insurance services to Peak. There is no evidence that Zumbaum had any experience in the insurance industry and he wasn't even aware of what was contained within the policies written by petitioner. Petitioner did not provide, whether on its own or through the use of third parties, the standard insurance industry services

typically found with an insurance company, such as underwriting, claims handling, claims payment, and loss prevention. Instead, petitioner's captive insurance arrangement created through Capstone was used by Zumbaum and Weikel to transfer Peak's profits to petitioner and transfer funds back to Peak as evidenced by the purported 2009 Claim, as discussed in Section II. B., above. Accordingly, petitioner did not act as an insurance company in the commonly accepted sense, but was rather a shell entity created by Capstone. Zumbuam and Weikel merely took on the role as directors of petitioner when it was required by Capstone in order to further their tax motivated arrangement.

B. Petitioner Did Not Distribute Risk

In analyzing risk distribution, the Court looks at the actions of the insurer because it is the insurer's, not the insured's, risk that is reduced by risk distribution. See Harper Grp., 96 T.C. at 57. "If there is neither adequate distribution of risk nor the financial power to withstand the simultaneous occurrence of all or a significant portion of the insured risks, there can be no transfer of risk, and hence no insurance." Gulf Oil Corp. v. Commissioner, 89 T.C. 1010, 1025 n.9 (1987).

In Securitas, the Court held that a captive "was exposed to a large pool of statistically independent risk exposures" because it received premiums from over 25 separate entities in

one year, 45 separate entities in another year, and its insureds had thousands of employees in over 20 countries, and operated over 2,250 vehicles. Securitas, T.C. Memo. 2014-225, *9. Similarly, in Rent-A-Center, the Court found risk distribution where 15 subsidiaries owned over 2,000 stores, operated in all 50 states, had over 14,000 employees, and operated over 7,000 vehicles. Rent-A-Center, 142 T.C. at 24.

i. Petitioner Failed To Substantiate Its Claimed Payment Of Reinsurance Premiums And, As A Result, Failed To Substantiate Its Claimed Participation In The PoolRe Quota Share Program

Neither the general ledgers nor the bank statements reflect any payments from petitioner to PoolRe for petitioner's participation in the Quota Share program. According to Feldman, Capstone was a "bookkeeper" for petitioner and would assemble the general ledgers based on bank statements provided by petitioner. (RPFFs 217, 218) Turning to the petitioner's bank statements, there is no proof of payment for the reinsurance premiums. Petitioner's bank statements reflect no payments from the accounts, other than the checks written for the 2009 Claim, the "settle-up" check in the amount of $5,250.00, and the funds transferred when the account with AmericanWest bank was closed to open the account with D.A. Davidson. (RPFFs 219-221) The agreement between PoolRe and petitioner for the Quota Share agreement required the payment of reinsurance premiums for each

of the taxable years at issue. Without payment of reinsurance premiums, petitioner was not a participant of the Quota Share program and did not distribute any risk through the pool program. Therefore, petitioner bore all the risk from the direct written policies for the taxable years at issue.

ii. Petitioner's "Risk" From CreditRe Was So Diluted That It Results In A De Minimis Amount Of Risk, Presuming There Is Substance To The Vehicle Service Contracts

Regarding the CreditRe arrangement, the issue of what documentation or substantiation exists regarding the vehicle service contracts is significant. Petitioner only presented testimony, but yet for a transaction involving so many alleged vehicle service contracts, there is no documentation to support what was involved in these contracts or what due diligence was conducted by petitioner before entering into the arrangement. Even if petitioner was able to show that there was substance to the vehicle service contracts and able to substantiate reinsurance payments were made, the amount of risk involved in these vehicle service contracts is completely *de minimis* to petitioner's risk portfolio. Based on the description of the CreditRe system, PoolRe held only 1.5% of the total alleged vehicle service contracts. (RPFF 182) Looking at the Quota Share arrangement for 2008, there were 52 participants in the pool that would equally take a share of the PoolRe's 1.5%. (RPFF 202) Using simple math (1.5% divided by 52 participants),

the result is that each member of the pool would take roughly .028% of the total vehicle service contracts initially from Linden. The Quota Share program for 2009 and 2010 had 53 and 58 participants, respectively, which further dilutes the alleged vehicle service contracts. (RPFFs 203, 204) Therefore, assuming the existence and number of the alleged vehicle service contracts could be substantiated, petitioner's risk was *de minimis*.

Thus, the concentration of risks solely with Peak signifies that Peak would pay for its own losses out of its own premiums as evidenced by the 2009 Claim paid by petitioner. Further, the policies petitioner underwrote only covered a small category of risk. The types of risks petitioner insured were not even faced by the small pool of participating insureds. The facts in this case in no way resemble Securitas or Rent-A-Center.

Lastly, petitioner did not adequately distribute risk of loss among a pool. The purported insureds were Peak, RocQuest and ZW Enterprises. Given the foregoing facts, RocQuest and ZW Enterprises failed to qualify as insured parties of petitioner. Peak essentially paid for its own risks through the captive insurance arrangement set up by Capstone, again merely transferring its profits to petitioner for the purpose of tax benefits.

C. Insurance Risk Did Not Shift to Petitioner

Peak, RocQuest, and ZW Enterprises did not shift risk to petitioner. Neither petitioner's premiums nor petitioner's capital were established in a manner to account for contingent historical losses or unexpected future losses. Instead, petitioner was formed and operated in a manner by Zumbaum and Weikel with the assistance of Capstone, using their arrangement and methods, to shelter Peak's profits for tax benefit purposes.

D. Petitioner's Captive Insurance Arrangement Does Not Involve The Existence Of "Insurance Risk"

For an arrangement to involve the existence of an insurance risk, the risk must contemplate the fortuitous occurrence of a stated contingency, Commissioner v. Treganowan, 183 F.2d 288, 290-291 (2d Cir. 1950), and must not be merely an investment or business risk. Helvering v. Le Gierse, 312 U.S. 531, 542 (1941); Rev. Rul. 2007-47, 2007 C.B. 127; Rev. Rul. 89-96, 1989-2 C.B. 114. The insured parties for the contracts at issue in this case were identified as Peak, RocQuest, and ZW Enterprises.

As discussed above, petitioner has failed to provide any evidence that would warrant a practical insurance risk exposure for the 13 excess policies in December 2008 or for the 11 excess policies in 2009 and 2010. As stated above, Peak maintained comprehensive insurance coverage during the taxable years at issue with commercial third parties.

During 2006 and 2007, Peak deducted insurance expenses in the amount of $38,810 and $95,828, respectively. (RPFFs 20,21) In 2008, prior to the formation of petitioner, Peak paid approximately $40,000 for insurance premiums related to its policies and had no losses of any significance. (RPFF 22) However, after the formation of petitioner, Peak's insurance premiums paid to petitioner totaled $412,089, $448,127, and $445,314 for the excess direct written insurance contracts for taxable years at issue, respectively, and these amounts were in addition to the third party insurance that Peak maintained. (RPFFs 23, 69, 81, 101).

For the foregoing reasons, petitioner's captive insurance arrangement does not qualify as insurance for federal income tax purposes as defined by the legal authorities cited above. Accordingly, petitioner was not an insurance company eligible to exclude premium income under section 501(c)(15).

IV. Petitioner Was Not A Tax-exempt Entity Under Section 501(c)(15) and, Consequently, Was Not Eligible To Make An Election Under Section 953(d)

Section 501(c) lists organizations that are exempt from taxation under section 501(a). One such entity is described in section 501(c)(15), which states in part:

> (A) Insurance companies (as defined in section 816(a)) other than life (including interinsurers and reciprocal underwriters) if-

> (i)(I) the gross receipts for the taxable year do not exceed $600,000, and
> (II) more than 50 percent of such gross receipts consist of premiums,… I.R.C. § 501(c)(15).

Section 816(a) defines an "insurance company" as "any company more than half of the business of which during the taxable year is the issuing of insurance or annuity contracts or the reinsuring of risks underwritten by insurance companies." Therefore, in order for an entity to be tax exempt under 501(c)(15), the entity must: 1) be engaged in the business of issuing insurance or reinsurance contracts for more than half of its total business; 2) receive gross receipts that do not exceed $600,000 for any one taxable year; and 3) receive more than 50 percent of its gross receipts as premiums on insurance contracts.

Petitioner fails the first and third requirements of section 501(c)(15). Petitioner's business does not consist of any issuance of insurance contracts or reinsurance within the meaning of section 816(a) for the taxable years at issue. See Sections II. & III. While petitioner received less than $600,000 in gross receipts for each of the taxable years at issue, none of the receipts consisted of premiums for insurance. Therefore, petitioner is not described in section 501(c)(15) and is not exempt from taxation under section 501(a).

Further, with its failure to qualify as an insurance company under section 501(c)(15), petitioner is ineligible to make an election pursuant to section 953(d) to be treated as a domestic corporation. Section 953 is only applicable to insurance companies. The definition of insurance company under section 953 carries a similar requirement as discussed previously regarding section 816(a) wherein more than 50% of taxpayer's business must be derived from written premiums from the issuance of insurance or reinsurance contracts. I.R.C. § 953(e)(3). As previously discussed, petitioner is not engaged in the business of issuing contracts for insurance or reinsurance. See Sections II. & III, above. Therefore, petitioner cannot make an election pursuant to section 953(d) and must be treated as a controlled foreign corporation for federal tax purposes. Accordingly, petitioner received gross income of $481,792, $548,059, and $561,017 for the taxable years 2008, 2009 and 2010, respectively, which was not exempt from tax.

V. Petitioner Is Subject To A 30 Percent Tax Imposed By Section 881 On Its U.S. Source Income For Each of the Taxable Years 2008, 2009, and 2010

Section 881(a) generally imposes a 30 percent tax on the amount received from sources within the United States by a foreign corporation as interest, dividends, rents, salaries, wages, premiums, annuities, compensations, remunerations,

emoluments, and other fixed or determinable annual or periodical gains, profits or income "but only to the extent the amount so received is not effectively connected with the trade or business within the United States." The term "fixed or determinable annual or periodical gains ("FDAP")" includes all types of gross income other than what has been excluded by regulations. Treas. Reg. § 1.1441-2(b)(1)(i),(ii). In summary, section 881(a) imposes a 30 percent tax on the amount received (1) from sources within the United States and (2) certain classes of income and FDAP income, which includes all income except those that have been excluded by regulation.

For the reasons discussed in Sections II. and III. above, petitioner did not engage in the business of insurance or any trade or business within the United States. The payments at issue represent periodic income received by petitioner (a foreign corporation) in furtherance of a transaction from a tax avoidance scheme. The fact that petitioner received the money and reported it as income is not in dispute, as shown on the Forms 990 filed by petitioner. Money received by petitioner from a U.S. source and without an exemption from taxation is subject to the withholding tax. Accordingly, the amount received by petitioner each year from this scheme was subject to a 30% tax under section 881(a)(1).

CONCLUSION

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

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