

Reserve Mechanical Corp. v. Comm'r: Tax Court Rejects Another Microcaptive Arrangement

Tax Alert
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On June 18, 2017, the Tax Court issued its opinion in *Reserve Mechanical Corp. v. Comm'r*, a case involving a microcaptive insurance company. In a memorandum opinion, the court—following *Avrahami v. Comm'r*—held that the microcaptive, Reserve, did not qualify as an insurance company because it did not distribute risk, and in the alternative, because it did not provide insurance in the commonly accepted sense. In reaching these conclusions, the court found that Reserve's risk pooling arrangement with another insurer did not qualify as insurance, the direct policies issued by Reserve served no legitimate business purpose, it charged unreasonable premiums, and did not offer insurance in the commonly accepted sense.

Before 2008, Norman Zumbaum and Cory Weikel owned several entities: Peak Mechanical & Components, Inc. (Peak), which distributed, serviced, repaired, and manufactured equipment for underground mining and construction; RocQuest, LLC (RocQuest), which owned real estate that was leased to Peak; and ZW Enterprises, LLC (ZW), which held an interest in a bar in Osburn, Idaho. During 2007, Peak reported insurance expenses of approximately \$96,000 and maintained policies with unrelated third-party insurers that covered risk relating to general liability, commercial property, commercial inland marine, and workers compensation. In 2008, Peak reached out to Capstone Associated Services, Ltd. (Capstone) to discuss the formation of a captive insurance company. Capstone was a firm that specialized in captive insurance company formation, management, and administration. Peak provided Capstone with documents relating to its business, financial and tax statements, and third-party insurance policies. In October 2008, Capstone incorporated Reserve Mechanical Corp. (Reserve) in Anguilla. Reserve obtained a general insurance license from the Anguillan government and was adequately capitalized under Anguillan law. Peak Casualty Holdings, LLC (Peak Casualty) owned 100 percent of Reserve's stock, and Zumbaum and Weikel owned 100 percent of Peak Casualty's stock.

In 2009, Capstone and Willis HRH of Houston, an insurance broker and risk management consulting firm, jointly issued a feasibility study for Peak. The study concluded that a microcaptive was "feasible, reasonable, and practical, and is the best alternative risk mechanism option for the proposed insured." During 2008 through 2010, Reserve wrote direct excess liability policies for Peak, RocQuest, and ZW as the named insureds with insurance premiums of \$412,089, \$448,127, and \$445,314, respectively. These policies included coverage for excess director and officer liability, excess pollution liability, excess cyber risk, loss of major customer, regulatory changes, punitive wrap liability, and other business-related risks. During the years in issue, Peak also maintained its insurance coverage with third-party insurers.

Reserve entered into a stop loss arrangement with PoolRe Insurance Corp. (PoolRe) for each year, equal to approximately 18-20 percent of the premiums that Reserve wrote. PoolRe entered into similar stop loss endorsements with approximately 50 Capstone clients. Reserve also entered into a reinsurance arrangement with PoolRe. Under a quota share reinsurance policy, Reserve (and the other Capstone captives that entered into the arrangement) agreed to provide coverage for a specified portion of the risks that PoolRe assumed pursuant to its stop loss endorsements. Under the quota share reinsurance arrangement, PoolRe agreed to pay Reserve reinsurance premiums equal to the amounts that Reserve paid to PoolRe under the stop loss endorsement (*i.e.*, approximately 18-20 percent of total premiums written each year). Reserve reinsured 1.35 percent of PoolRe's stop loss pool for 2008 and 1.44 percent of PoolRe's stop loss pool for 2009 and 2010. Finally, under coinsurance contracts, Reserve agreed to assume a portion of risk that PoolRe had assumed from an unrelated party relating to a vehicle service contract reinsurance treaty. Under the coinsurance contracts, Reserve assumed .99 percent, 1.16 percent, and .91 percent of PoolRe's annualized vehicle service liability for the years in issue, respectively. The premiums received by Reserve under the coinsurance contracts were approximately 13-15 percent of Reserve's total premiums for each year.

Reserve elected to be treated as a domestic corporation under I.R.C. § 953(d) and also claimed that it was exempt from tax under I.R.C. § 501(c)(15). A non-life insurance company can qualify for tax exempt treatment under I.R.C. § 501(c)(15) if: (1) its gross receipts do not exceed \$600,000 and (2) more than 50 percent of its receipts consist of insurance premiums.

The court began by considering whether Reserve's contracts with Peak and the other insureds were insurance for federal tax purposes. The court cited four criteria for evaluating whether an arrangement constitutes insurance: (1) insurable risk; (2) risk shifting; (3) risk distribution; and (4) commonly-accepted notions of insurance. Starting with risk distribution, the court looked at Reserve's direct written policies and noted that "most or all of the risks were associated with the business operations of just one insured," Peak. Thus, the court concluded that Reserve's direct written policies did not result in risk distribution because "the number of insureds and the total number of independent exposures were too few." The court then considered whether the 30 percent of Reserve's premium revenue attributable to unrelated parties (through the PoolRe quota share agreement and the credit coinsurance contracts) resulted in risk distribution. As in *Avrahami*, the court refused to respect the pooling arrangement as providing valid insurance.

The court began by evaluating six factors to determine whether PoolRe was a bona fide insurance company. First, the court noted that the quota share arrangement between PoolRe and Reserve "look[ed] suspiciously like a circular flow of funds." The court also noted that the parties executed two of the quota share agreements before PoolRe obtained a valid Anguillan insurance license. For the remaining four factors, the court held that Reserve failed to introduce sufficient evidence to establish that PoolRe was a bona fide insurance company. Specifically, the court held that Reserve did not establish that the contracts were calculated at arm's length, failed to introduce evidence showing the other industries and risks that were pooled and distributed by PoolRe, provided no evidence of the future likelihood of purported losses that would trigger PoolRe's stop loss coverage, and did not establish that PoolRe was created or operated for legitimate nontax reasons.

The court also found that Reserve failed to introduce evidence to establish that the vehicle service contracts underlying the coinsurance contracts existed or that the transactions involved actual risk. The court stated that even if it found that the vehicle coinsurance contracts were valid, "any actual risk that PoolRe had in connection with the vehicle service contracts was *de minimis*, because PoolRe assumed liability for a small, blended portion of the overall pool of vehicle service contracts, and it re-ceded most or all of that liability to the Capstone entities" through the coinsurance contracts. Notably, because the premiums were less than 20 percent of Reserve's total premiums, a finding that the coinsurance was valid insurance was unlikely to change the court's holding: it is unlikely that the court would have concluded that risk distributions was present. See *Harper Grp. v. Commissioner*, 96 T.C. 45, 59-60 (1991), *aff'd*, 979 F.2d 1341 (9th Cir. 1992). But the court's holding on this point is troublesome because there is no legal support for the principle that the coinsurance provided by PoolRe for a small portion of a valid insurance pool should be disregarded merely based on its size in relation to the overall pool. In addition, the fact that PoolRe ceded that risk to Reserve and other participants should have no impact on its character as insurance risk to PoolRe.

While the absence of risk distribution was enough for the court to conclude that the Reserve arrangement was not insurance, the court also considered whether Reserve's arrangement was insurance in the commonly accepted sense. The court evaluated a number of factors including some that were favorable or neutral to Reserve's position: (1) Reserve complied with Anguillan law and was adequately capitalized; (2) there was "mixed evidence" regarding the validity of Reserve's policies, and (3) Reserve actually paid one claim. But the court concluded that the arrangement was not insurance in the commonly accepted sense because Reserve was not operated as an insurance company, Reserve's owners did not participate in the structuring or execution of its "insurance" transactions, Reserve did not perform due diligence in vetting the direct contracts or reinsurance policies, and Reserve handled the only claim that was filed under the policies "in an irregular manner." Moreover, although Reserve's premiums were calculated using objective criteria and "what appear to be actuarial methods," the court found that the facts did not show that Peak had a genuine need for acquiring the insurance in the years at issue. It also noted that the direct written policies were not the result of arm's length negotiations and no unrelated party would have paid the premiums that Peak and the other companies paid for the coverage provided. The court held that "the absence of a real business purpose for Reserve's policies leads us to conclude that the premiums paid for the policies were not reasonable and not negotiated at arm's length."

Based on the court's holdings regarding risk distribution and insurance in the commonly accepted sense, Reserve was not an insurance company for federal tax purposes during the years in issue. The court determined, therefore, that Reserve was a foreign corporation because it was not eligible to make an election under I.R.C. § 953(d). Because Reserve was a foreign corporation, under I.R.C. § 881(a)(1) it was subject to a 30 percent tax on the "fixed or determinable annual or periodical" income (FDAP income) that it received from sources within the United States. Reserve's FDAP income included all of its premiums except for the gross premiums attributable to the coinsurance contracts.

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