

# How the Tax Court Rewrote the Standards for Insurance Policy Selection

Does Captive Insurance Exist After the *Reserve* Decision?  
Commentary #3 by Capstone Associated Services, Ltd.

## Table of Contents

Contents	Page
Background on Business Operations of Reserve’s Insureds	1
Witnesses Testifying at Trial	4
Parties Before the Court	5
Government’s “Tax Shelter” and “Business Purpose” Themes – Adopted by the Court Without Supporting Evidence	6
Reserve’s Direct Policies All Were Non-Duplicative and Complimentary to the Insureds’ Commercial Policies	9
Reserve’s Administrative and Professional Team	12
The Pooling Arrangement	14
Evidentiary Issues – The Court’s Unsupported Factual Findings	17
New Concepts Introduced by This Court on Insurance Policy Selection and Related Issues	20
A. <b>Insurer</b> Must Show an <b>Insured’s</b> “Business Purpose” for a Policy to be Considered Insurance	20
B. Insureds Must Show Previous Actual Loss History for a Policy to be Insurance	24
C. Commercial Policies Must First Be Exhausted for a Policy to be Insurance	25
D. PoolRe Must be a “Bona Fide Insurance Company” – A Non-Contested Issue at Trial	26
Endnotes	28

## ***Commentary #3 by Capstone Associated Services, Ltd.***

# **Does Captive Insurance Exist After the *Reserve* Decision?**

## **How the Tax Court Rewrote the Standards for Insurance Policy Selection**

### **Commentary on Insurance Policy Selection and Related Issues**

*Reserve Mechanical Corp. f.k.a. Reserve Casualty Corp. v. Commissioner of Internal Revenue* (“*Reserve*”) was decided by the United States Tax Court in an opinion issued by Judge Kathleen Kerrigan (the “Opinion”) on June 18, 2018.

In our continuing series on the recent opinion issued in *Reserve*, this third commentary addresses the issues involving insurance policy selection and related issues raised in the case. The Opinion and trial transcript can be found [here](#), along with additional links to the opening briefs, reply briefs, and post-briefing issues memoranda (regarding *Avrahami*) that were filed both by Petitioner (*Reserve*) and by Respondent (Internal Revenue Service) in *Reserve*.

Because the Opinion in *Reserve* departs so markedly from the evidence and issues presented at trial, any serious analysis must be based on a review of the trial transcript, the expert reports, and the post-trial briefing. For these reasons, links to such have been provided above.

*Reserve* filed a Motion for Reconsideration on a single issue with the Tax Court on July 18, 2018 (subsequently denied), which can be found [here](#). The final decision in the case was entered on September 28, 2018 which can be found [here](#).

Capstone’s initial statement and two previous commentaries on the Court’s Opinion can be found [here](#).

### **Background on Business Operations of *Reserve*’s Insureds**

The Court heard testimony from Norman Zumbaum, the President of *Reserve* and an owner of the insureds as follows: Peak Mechanical & Components, Inc. (“Peak”) of Osburn, Idaho distributed, serviced, manufactured and repaired equipment used in underground mining operations, typically 5,000 – 8,000 feet underground.<sup>1</sup> Additionally, Peak disassembled and rebuilt trucks, replacing the original engine with one able to operate in deep mine shafts.<sup>2</sup> Peak also manufactured and repaired guide wheels for vertical hoist conveyances, which were used to transport workers and materials thousands of feet down into mines.<sup>3</sup>

Peak’s Idaho offices and manufacturing facilities are physically within the Bunker Hill Mining & Metallurgical Complex, a “Superfund Site” designated as such by the U.S. Environmental Protection Agency (EPA) (the “Bunker Hill Superfund Site”).<sup>4</sup> As part of its business, Peak rehabbed and cleaned contaminated mining equipment at its Osburn, Idaho facilities<sup>5</sup> and worked in contaminated mines. The Bunker Hill Superfund Site has ongoing cleanup activities which are expected to continue for 50 to 60 years.<sup>6</sup> As such, the Bunker Hill Superfund Site

(that is, Peak's facilities) is subject to continuous regulation because it is polluted with heavy metals as a result of historic mining practices.<sup>7</sup> Peak's facilities are subject to ongoing EPA oversight and regulation.<sup>8</sup>

Peak's facilities (land and buildings) are owned by RocQuest, one of Reserve's insureds and leased to Peak.<sup>9</sup> Under the "Superfund" statute (enacted as the Comprehensive Environmental Response, Compensation, and Liability Act ("CERCLA") in 1980),<sup>10</sup> discussed further below, the EPA is empowered to identify parties responsible for hazardous substances that are released into the environment (by polluters) and either compel them to clean up the sites, or it may undertake the cleanup on its own using the Superfund (a trust fund) and recover its costs from polluters by referring responsible parties to the U.S. Department of Justice.

During the tax years in issue (2008 - 2010), Peak's equipment was used in mines in Idaho, Nevada, Washington State and internationally, as far away as Australia. Included among Peak's manufactured and serviced products is a line of submersible pumps that are used to prevent flooding in underground work areas.<sup>11</sup> Peak also supplies large ventilation fans and air barrier doors, used to maintain breathable air in these deep underground mines.<sup>12</sup>

As discussed below, after not having been able to secure pollution liability insurance, among other coverages, from the commercial markets, Peak and the other insureds participated in the formation of Reserve. Congress enacted Section 501(c)(15)<sup>13</sup> with origins dating back almost 100 years to facilitate businesses' acquiring insurance coverages from affiliates. The case law applicable to "insurance" and "insurance companies" is undistinguished by whether the entity operates under IRC Section 501(c)(15), 831(b) or 831(a).

In addition to providing testimony about the operations of the three non-party affiliated insureds (the "Peak insureds"), Mr. Zumbaum (among others) also testified about the operations of Reserve, the captive insurer.<sup>14</sup> Mr. Zumbaum testified that he relied on his professional team of advisors, including Capstone Associated Services, Ltd., in connection with Reserve's operations.<sup>15</sup> Despite this testimony, the Court concluded that "Zumbaum, Reserve's 50% owner and chief executive officer, knew virtually nothing about [Reserve's] operations."<sup>16</sup> The Court apparently expected the insureds' CEO, who runs a mining equipment operation, to be more conversant in property and casualty insurance matters despite his testimony that he delegates insurance operations to an experienced professional team. Although Mr. Zumbaum did not deny any responsibility for Reserve's operations, the Court created and imposed a new standard by requiring a CEO to be fluid in his knowledge of the insurer's operations rather than reasonably relying on the expertise of the recognized professional team.

All policies issued by Reserve to its three affiliated insureds (separate and apart from the thousands of unaffiliated insureds) were crafted (as were the commercial policies) to meet the insureds' specific business needs, and, as explained below, none of Reserve's policies duplicated Peak's commercial policies.

The other two entities insured under Reserve's direct written policies (RocQuest, LLC and ZW Enterprises, LLC) conducted more limited operations than Peak, with RocQuest owning significant real estate (Peak's facilities).<sup>17</sup> Reserve also underwrote coverages to a diverse range

of third-party insureds, including 200+ unaffiliated insureds on 650+ policies (in 2010 for example) through a PoolRe administered pooling arrangement<sup>18</sup> and thousands of other non-affiliates on reinsurance assumed from a publicly-held insurer, Lyndon.<sup>19</sup> As with any captive insurance arrangement, the focus of Reserve's direct written coverages was on Peak. The other two affiliated entities were additional named insureds under the policies,<sup>20</sup> as is customary in the insurance industry for affiliated companies.<sup>21</sup>

Among the criticisms leveled at Reserve in the Opinion was that the Court implied that there was an obligation of the *insurer* to segregate its billings among each named insured. This concept was raised *sua sponte* by the Court, which stated as follows at page 14 of the Opinion: "All of the policies that Reserve issued the [three] insureds showed only one premium price and did not specify amounts to be paid by each insured." The other two insureds (ZW and RocQuest) were "additional named insureds" under the policy, with the Opinion criticizing the ubiquitous and long-standing insurance practice in both personal and commercial insurance lines wherein the first named insured is listed along with the Additional Named Insureds on a single policy without further breakdown of charges, when all insureds are affiliates under common control, with only one overall premium charge specified. There was no testimony or other evidence challenging this practice, which the Court spontaneously raised in the Opinion. If allocated policy pricing were ever an issue, it is one for the insureds (not for Reserve, the insurer) calling for a Section 482 adjustment if the allocation among insureds was improper. However, the insureds were not parties to the tax court case and no issue of misallocation of premiums among the insureds was raised at trial. The Court appeared to ascribe the fault it fashioned to Reserve. However, this is not an issue for Reserve, which properly reported the revenue from all insureds. This was one of many examples of the Court announcing requirements nowhere previously imposed in any precedent and likewise not argued at trial.

The Court *sua sponte* and without precedent imposed a new requirement on an insurer to allocate premiums among its insureds as a condition of the contract being considered insurance, and then holding Reserve to such. The Court was not constrained by this not being an issue at trial and without the benefit of evidence.

The Court's lodged complaint represents a first for the insurance industry as to the alleged impropriety of an insurer in issuing policies without allocating premiums among named insureds. By way of example, even a homeowners or automobile policy will typically list family members and perhaps their business and rental properties as insureds under a single policy offered for a single premium. While perhaps an argument can be made that an IRC section 482 allocation *among the insureds* might exist if the insureds were (as was not the case here) before the Court, the Court somehow ascribed the responsibility for premium allocation to Reserve, which accepted the risks associated with the three insureds for the given policies for the called for premium. The Court simply manufactured this issue on its own; the IRS never objected to or even raised this as an issue at trial.

Contrary to the Court's criticism of Reserve's standard premium billing arrangement, the only testimony at trial regarding this issue established that it is not unusual for a single premium price to be charged by an insurer for multiple named insureds where similar ownership exists.<sup>22</sup> This testimony was not controverted. However, Reserve's standard billing practices and those of the

entire insurance industry were rejected by the Court without any citation to authority or otherwise explaining the Court's reasoning. The Court went outside the record to create an issue where there was none at trial.

### **Witnesses Testifying at Trial**

At trial, Reserve presented the testimony of 10 witnesses, including seven recognized experts. Among them were (i) two independent full Fellows of the Casualty Actuarial Society (FCAS), both also holding the Member of the American Academy of Actuaries (MAAA) designation, testifying as to the reasonableness of premiums' pricing;<sup>23</sup> (ii) a nationally recognized Ph.D.-credentialed insurance economist from The Wharton School, testifying on risk distribution, the pooling structure and the insurance arrangements with the publicly-held insurer, Lyndon, in which Reserve participated;<sup>24</sup> (iii) a dual credentialed Chartered Property & Casualty Underwriter (CPCU) and Associate of Risk Management (ARM), with 30+ years' experience at international insurance brokerages, who assisted in the development of premiums charged by Reserve and the setting of the premiums;<sup>25</sup> (iv) the Delaware Director of Captive and Financial Insurance, who is also a lawyer and an insurance regulator having decades of experience;<sup>26</sup> and (v) a licensed CPA with decades of experience in captive insurance accounting matters.<sup>27</sup> Among the other witnesses was (i) a member of the insurance pooling arrangement's board of directors, himself a senior vice president of a global risk advisory firm, with decades of relevant insurance industry experience in addition to his being a licensed attorney and having the professional designation as an Associate in Risk Management (ARM),<sup>28</sup> and (ii) another actuary designated as an expert holding both the Fellow of the Society of Actuaries (FSA) and MAAA professional designations who served as advisor to yet another third party insurance program in which Reserve participated.<sup>29</sup> Finally, unchallenged documentary evidence was received from yet another FCAS actuary who actuarially priced the insurance pool.<sup>30</sup>

In contrast, the government called a single expert, Donald Riggin, a CPCU, who testified on only a narrow range of issues. Among the issues on which he expressly declined to testify was on the pricing of any insurance policy.<sup>31</sup>

Reserve called experts testifying on the following: (1) that the policies underwritten by Reserve during 2008, 2009 and 2010 covered insurable risks of Peak and other insureds (both affiliated and not), which were risks that the insurance industry considers to be insurable risks<sup>32</sup> and which would be widely recognized by academics and insurance professionals as insurable risks<sup>33</sup>, (2) that the premiums charged for each of the policies written by Reserve were reasonable<sup>34</sup>, (3) that Reserve was regulated in a manner consistent with the laws of a United Kingdom territory (Anguilla), which were similar to those of the State of Delaware cite, and that the policies issued by Reserve transferred "insurance risk" in accordance with such laws,<sup>35</sup> (4) that Reserve was adequately capitalized in a manner that satisfied both domicile law and regulatory norms,<sup>36</sup> and (5) that Reserve was in compliance with all applicable financial accounting principles.<sup>37</sup>

Before the captive's policies were bound and issued, the insurance underwriters conducted an on-site examination in northeastern Idaho of the insureds' operations, resulting in a feasibility study report being jointly authored by [Willis](#), an independent global risk advisory firm, and Capstone.

None of Reserve's direct written policies duplicated any of Peak's coverages under commercial policies.<sup>38</sup>

As noted briefly above, only one substantive witness, presented as an expert with a CPCU designation, testified for the government. *Despite not having an opinion on pricing of any of the policies* other than conjecture that the policies couldn't have been correct because they were not a result of "a formal, quantitative, mathematically-based methodology,"<sup>39</sup> the government's witness admitted that at least 11 of the 14 policies underwritten by Reserve would be insurance policies (at least in part) covering legitimate risks if analytically based premiums could be established for such policies.<sup>40</sup> Seven experts (including three actuaries, Dr. Doherty and CPCU McNeel) testified to the contrary regarding the policy pricing methodology asserted by the government's expert, Riggin. Government expert Riggin did not provide any testimony on the pricing of Reserve's direct written policies beyond this conjecture that Reserve couldn't possibly have priced premiums "correctly" because it likely did not have access to a particular pricing manual compiled by a data analytics company, Verisk Analytics, that is one of many publishers of insurance data and forms for certain standard policies.<sup>41</sup> According to this witness, absent access to this Commercial Lines Manual (one of Verisk Analytics' products), any pricing methodology would require a significant amount of loss data.<sup>42</sup> Even the Court ultimately – if reluctantly – concluded that Reserve's premiums were calculated "using objective criteria and what appear to be actuarial methods."<sup>43</sup> By making this statement in the Opinion, the Court implicitly recognized that at least 11 of 14 contracts directly underwritten by Reserve (without regard to the 650+ pooled policies or the Lyndon based reinsurance assumed) were insurance policies (in whole or in part) for tax purposes, despite the Court ultimately concluding otherwise across the board in the Opinion.

### **Parties Before the Court**

Only Reserve, the insurer, was before the Court. None of (i) the participants in the pooling arrangement or the entity administering the pool, PoolRe Insurance Corp. ("PoolRe"), (ii) any insureds under any of the many hundreds of policies underwritten (and reinsured) by Reserve, (iii) the beneficial owners of any of the insureds or (iv) the original ceding insurer under the third-party insurance program were parties to the case or otherwise before the Court nor were any of these parties deposed by the government.

Despite such and in the face of uncontroverted evidence, the Court adjudicated issues of non-parties, such as the insurance pooling/risk diversification program administered by PoolRe<sup>44</sup>, rather than limiting findings to the only party before the Court.<sup>45</sup> The government never challenged PoolRe's status as an insurer in its post-trial opening brief, with the challenge to PoolRe arising for the first time in the government's post-trial reply brief, which was filed *after* the issuance of the opinion in *Avrahami*. Neither did the government offer any evidence to challenge Lyndon's third-party insurance that was ceded to Reserve from an unaffiliated, publicly-held commercial carrier, which the Court nonetheless also concluded was "not insurance"<sup>46</sup> despite this insurance arrangement never being controverted at trial.<sup>47</sup> The Court was clearly erroneous in so finding.

## Government's "Tax Shelter" and "Business Purpose" Themes – Adopted by the Court Without Supporting Evidence

Fundamentally, the Court seems to have adopted the theme articulated by the government *only in its opening statement*, but not carried through by any witness or in any documentary evidence. The government argued in its opening statement that Reserve's insurance arrangement was essentially a tax shelter and that the insurance arrangement did not have a legitimate business purpose.<sup>48</sup> The fact that the insurer was formed and operated pursuant to a statutory provision of the Code, Section 501(c)(15), which was enacted to benefit small property and casualty insurers, did not stop the Court from adopting requirements for insurance never before seen.

The government's main arguments at trial focused on whether (1) Reserve sufficiently distributed risk among its policyholders and (2) the policies written by Reserve were policies of insurance and thus whether its transactions were insurance transactions "in the commonly accepted sense."

Neither the testimony of the government's sole witness nor the cross examination of any of Reserve's witnesses supported the government's opening theory that the sole purpose of Reserve's insurance arrangement was to enable Reserve's owners to "move money from one pocket to another for the sole purpose of reducing their taxable income." The Court never acknowledged that the movement of the monies were from the three insureds, each a distinct taxpayer, to Reserve as the regulated insurer and a separate, distinct taxpayer. There can be no reasonable assertion that this is a "circular flow of funds."<sup>49</sup> The Court conflated the common ownership of these entities, disregarding their distinctiveness without explanation. Yet, in enacting Section 501(c)(15) and Sections 831(a) and (b) of the Code, Congress clearly envisioned that the insureds and the insurer could be related parties in the typical captive insurance arrangement.<sup>50</sup>

This Court seemed offended by the affiliated nature of the arrangement, which, as is the case of an individual retirement plan or a health savings account, can be said to function to "move money from one pocket to another" and is authorized by Congress to do so. Compliance with federal legislation cannot support a conclusion that the sole purpose of an arrangement is to reduce taxable income, as asserted by the Court, especially when no contrary evidence is offered or cited.<sup>51</sup> The Court reached this erroneous conclusion in the face of many hundreds of insurance policies being underwritten by Reserve to third parties, with \$187,891.99 of losses being paid by Reserve to unaffiliated parties<sup>52</sup> and \$339,880 in losses being paid by Reserve to Peak during the three years at issue.

The Court seemed (improperly) to elevate its subjective view as to the intent of Reserve's insureds (who nonetheless were not before the Court) over the form and substance of the transaction. In this unpublished tax court memorandum decision,<sup>53</sup> the Court did not address the testimony of Reserve's expert and fact witnesses, whose testimony was largely unchallenged. Among its errors, the Court *sua sponte* imposed a newly announced test *that a "for-profit" insurance company must satisfy: Its insureds must have a valid business purpose for acquiring policies as a condition of the insurer being an insurance company for tax purposes.* The Court

implicitly found that it is not sufficient for a “for-profit” insurance company to have as its “business purpose” its desire to earn a profit from underwriting insurance policies and investing its reserves in a profitable manner. Rather, according to the Court, the insurer must delve into “why” an insurance policy is being purchased by a prospective insured. In the absence of a non-party satisfying a court as to this subjective test, despite such not even being a trial issue, a policy issuer (according to the Court) fails to be an insurer. The Court imputed its view of the subjective motive of the insureds onto the insurer, looking into the psyche of the non-party insureds, to challenge the existence of this subjective intent. The Court nowhere explained from where this new announced concept emanated. The Court was not limited in its analysis by the fact that the insureds were not parties. Furthermore, the Court went outside the record in choosing to set the bar on a number of issues beyond Reserve’s grasp.

Of even more concern, the Court rejected the uncontradicted articulated reasons of the insureds, as reflected in the independently-produced feasibility study, in the issued policies and in the testimony of Mr. Zumbaum, that the insureds sought out the additional insurance coverage after consultation with its commercial brokers and other advisors, when these coverages were found to be needed but not to be commercially available or were unreasonably priced.<sup>54</sup>

Although the government’s 90-day letter (“notice of deficiency”) generally alleged that Reserve’s purported insurance transactions and/or reinsurance transactions “lack[ed] economic substance,”<sup>55</sup> the government’s case at trial did not address the subjective intent of the insureds or the business purpose of the insurance. Despite the testimony offered by Reserve’s president, the insurance policies in evidence and the upfront produced feasibility study, the whole of the trial transcript (other than the government’s opening statement) is devoid of a government complaint about “business purpose.” Given the coverages tailored to the Peak insureds by the policies, and the hundreds of thousands of dollars in actual insured losses paid by Reserve to its insureds, the Court’s ruling on lack of business purpose cannot be reconciled with the insurance claims paid by Reserve and that Reserve was operated consistent with recognized insurance practices and the laws of its domicile.

In furtherance of this unexplainable position, the Court found that Peak did not have a “genuine need” for acquiring the direct written policies from Reserve<sup>56</sup> and then concluded that there was no legitimate business purpose for the policies that Reserve issued to the insureds.<sup>57</sup> In doing so, the Court stated that it was not reasonable for the Peak insureds to acquire a pollution liability policy despite being located in a Superfund site. According to this Court, neither was it reasonable for Reserve to issue a Loss of Major Customer policy to Peak, despite Reserve paying a \$339,880 claim for losses suffered by Peak under the terms of the outstanding insurance policy. On the one hand, the Court treated these losses as taxable income (in fact, taxing them twice as such), and, on the other hand, the Court ignored the claims being paid under the policies as evidence of there being an insurance program in place.

Carried to its logical next step, a mortgage company would not record revenue on a mortgage not needed by a borrower. Nor would a health insurer record revenue for a health insurance policy for a healthy 25-year-old who “doesn’t need” health insurance. Nor should claims be paid. The Court’s announcement stands in stark contrast with common sense. The purpose of insurance is



to cover insureds' fortuitous prospective risks<sup>58</sup> and not risks that the Court rejects, substituting its business judgment for the business judgment of the insureds' management.

This Court's limited analysis in *Reserve* focused on what the Court thought the law should be – putting itself into a legislative role – despite the taxpayers' compliance with the substance and form of what has been set out by Congress in legislation and what over decades has been interpreted by the courts. Appellate courts have recently made clear to this same Court that its role is not to block Congress' legislation enabling a taxpayer to qualify for tax benefits as a result of satisfying the requirements of the Internal Revenue Code. In *Summa Holdings Inc. v. Commissioner*,<sup>59</sup> the Sixth Circuit held that the taxpayers were entitled to use a congressionally created corporation – a “domestic international sales corporation” (DISC) – to transfer money from their family-owned company to their sons' Roth Individual Retirement Accounts (IRAs). When the taxpayers in *Summa* did just that, the government challenged the transactions and argued that the effect of these transactions was to evade the contribution limits on Roth IRAs and attempted to apply the “substance-over-form doctrine.” In holding that the taxpayer's “DISC – Roth IRA” transactions were permissible, the Sixth Circuit reversed this Court stating:

***“Each word of the ‘substance-over-form doctrine,’ at least as the Commissioner has used it here, should give pause. If the government can undo transactions that the terms of the Code expressly authorize, it’s fair to ask what the point of making these terms accessible to the taxpayer and binding on the tax collector is. ‘Form’ is ‘substance’ when it comes to law. The words of law (its form) determine content (its substance). How odd, then, to permit the tax collector to reverse the sequence – to allow him to determine the substance of a law and to make it govern “over” the written form of the law – and to call it a “doctrine” no less.”***<sup>60</sup>

In the related case of *Benenson v. Commissioner*,<sup>61</sup> the First Circuit later stated:

***“By design, Congress and the Treasury Department allowed domestic companies to defer taxation and pay out dividends to shareholders through a structure that might otherwise run afoul of the Code. See Addison Int'l, Inc. v. Comm'r, 90 T.C. 1207, 1221 (1988); see also *Summa Holdings*, 848 F.3d at 786 (“By congressional design, DISCs are all form and no substance....”). In sum, we agree with the Sixth Circuit that Congress created DISCs “to enable exporters to defer corporate income tax.”***<sup>62</sup>

***“Some may call the Benensons’ transaction clever. Others may call it unseemly. The sole question presented to us is whether the Commissioner has the power to call it a violation of the Tax Code. We hold that he does not. The substance over form doctrine is not a smell test. It is, in this circuit, a tool of statutory interpretation. When, as here, we find that the transaction does not violate the plain intent of the relevant statutes, we can push the doctrine no further.”***<sup>63</sup>

The Court in *Reserve*, squarely based on *Avrahami*, went far beyond any earlier opinions in the captive insurance area, establishing new law and new requirements for “insurance” without articulating the principles or basis for such holdings other than its own views. The Court's new holdings never before seen anywhere are discussed below beginning at page 20.

## **Reserve's Direct Policies All Were Non-Duplicative and Complimentary to the Insureds' Commercial Policies**

Reserve underwrote and issued property and casualty policies in three categories: (i) direct written policies (11-13 policies per year for 2008-2010) issued to its affiliated insureds; (ii) pooled premiums from, for example in 2010, 650+ policies (98+% of which were policies issued by PoolRe to businesses wholly-unaffiliated with Reserve); and (iii) reinsurance assumed by Reserve with respect to policies issued to many tens of thousands of wholly-unaffiliated insureds by Lyndon, a publicly-held, commercial insurer.

The commercial insurance coverages maintained by Peak with third-party commercial carriers for the tax years at issue (2008 – 2010) provided limited coverage:

### **Commercial Policies**

<b><u>Insurer</u></b>	<b><u>Policy Description</u></b>	<b><u>Policy Limits</u></b>
Employers Mutual Casualty Co. (EMC)	General liability (damage to rent premises, medical expense, personal and advertising injury, products/completed operations)	Ranging from \$5,000 - \$2 million depending on the category of coverage
EMC	Commercial Property	\$914,940
EMC	Commercial Inland Marine	\$8,000
Idaho State Insurance Fund	Workers compensation employer's liability	\$500,000 aggregate policy limit
Ace American Insurance Co.	International risk policy (foreign general liability, automobile liability, employer's liability); foreign accidental death and dismemberment; kidnap & extortion	Ranging from \$5,000 - \$1 million depending on category of coverage
State Farm	Auto liability for vehicles driven by employees	Differing limits depending on type of vehicle insured and category of coverage (bodily injury, property damage, etc.)

IRC Section 501(c)(15), similar to IRC Section 831(b), expresses Congress' intent to encourage businesses to broadly insure their risks by facilitating setting aside monies to fund future losses in an insurer, which need not be unrelated, all in furtherance of enhancing the long-term success of such businesses. Statutory tax incentives are provided to encourage insurance company formation for small businesses. In the case of IRC Section 501(c)(15), a property and casualty insurance company is generally exempt from federal income tax if (1) its gross receipts for the taxable year do not exceed \$600,000, and (2) more than 50 percent of such gross receipts consist of insurance premiums.<sup>64</sup> Taxes are payable by the shareholders of the insurer upon the insurer's liquidation<sup>65</sup> resulting in at best a deferral, not an avoidance, of tax. Analogous deferral provisions exist under Code Section 831(a) and (b). There have been numerous cases involving captive insurance arrangements over the last 40+ years, in which the taxpayer has succeeded in overcoming government challenges.<sup>66</sup> These case precedents addressed what constitutes an

“insurance company” for federal income tax purposes and do not distinguish between a “small” versus “large” captives. The only cases addressing “small” captives are *Avrahami v. Commissioner*<sup>67</sup> in 2017 (regarding Section 831(b)) and now *Reserve* (regarding Section 501(c)(15)) in 2018. Yet, the Court has created differing standards for these small insurers, unsupported by authority.

As noted, the *Avrahami* Opinion was issued after the conclusion of trial in *Reserve* but before briefing was completed. Nonetheless, the Court’s approach was to decide *Reserve* as if it were in the same jurisdictional and factual posture as *Avrahami*, demanding evidence with respect to issues that were not even contested by the parties during the *Reserve* trial but which were at issue in *Avrahami*. As discussed below, the *Reserve* Court improperly shoehorned its findings to fit them within the holdings of the *Avrahami* opinion.

Reserve issued insurance policies nonduplicative with any of its direct insureds’ commercial policies. All of Reserve’s policies were *jointly written* by Reserve and PoolRe (between 11 and 13 direct written policies, depending on the year at issue) as follows:

#### **Policies Issued by Reserve**

<b><u>Joint Insurers</u></b>	<b><u>Policy Description</u></b>	<b><u>Policy limits for 2008,2009 &amp; 2010, respectively</u></b>
Reserve/PoolRe	Excess Directors & Officers Liability	\$1 million, \$1 million, \$1 million
Reserve/PoolRe	Special Risk – Loss of Major Customer	\$1 million, \$500,000, \$500,000
Reserve/PoolRe	Special Risk – Expense Reimbursement	\$1 million, \$1 million, \$1 million
Reserve/PoolRe	Special Risk – Loss of Services	
Reserve/PoolRe	Special Risk – Weather Related Business Interruption (2008 only)	\$1 million, N/A, N/A
Reserve/PoolRe	Excess Pollution Liability	\$1 million, \$500,000, \$500,000
Reserve/PoolRe	Special Risk – Tax Liability	\$1 million, \$500,000, \$500,000
Reserve/PoolRe	Excess Intellectual Property Package	\$1 million, \$1 million, \$1 million
Reserve/PoolRe	Special Risk – Regulatory Changes	\$1 million, \$500,000, \$500,000
Reserve/PoolRe	Special Risk – Punitive Wrap	\$1 million, \$500,000, \$500,000
Reserve/PoolRe	Excess Employment Practices Liability (2008 only)	\$1 million, N/A, N/A
Reserve/PoolRe	Excess Cyber Risk (2008 only)	\$1 million, N/A, N/A
Reserve/PoolRe	Legal Expense Reimbursement (2009 and 2010 only)	N/A, \$1 million, \$1 million
Reserve/PoolRe	Special Risk – Product Recall	\$1 million, \$500,000, \$500,000

Under the joint underwriting agreement, PoolRe’s participation with Reserve is limited to an intermediate loss layer above a threshold borne solely by Reserve. See Diagram 1 at page 15, which depicts the tranches of risk borne by each respective party in connection with Reserve and PoolRe’s underwriting.<sup>68</sup> This is a typical risk spreading arrangement whereby the insurer (and the insureds) seeks to limit and spread risk. In the context of an individual, Reserve’s policies are analogous to an umbrella policy which only sits over a low face value homeowner’s, auto policy or general liability policy, while also filling in the holes and gaps. As reflected in the tables above, some of the risks insured differed slightly from year-to-year as the insureds and the

insurer refined their arrangement. Similarly, the policy pricing differed from year-to-year based on market conditions, scope of coverage, pricing factors, and other factors.<sup>69</sup>

For each captive insurer that participated in PoolRe, the captive's policies were individually evaluated, underwritten and priced based upon the risk profile of its insureds for each offered policy, taking into account factors such as the insureds' revenue, employment, size of facilities, etc. as the case may be for each insured.<sup>70</sup> Nonetheless, without any proof to the contrary and ignoring the uncontested testimony that such was the case, the Court (erroneously) concluded that the 650+ policies in the pool were priced using a "one-size-fits-all" rate.<sup>71</sup> Finding against Reserve, the Court seized on this uncontroverted fact for which Reserve additionally carried its burden of proof. The Court brushed aside the evidence and presented no analysis as to its "one-size-fits-all" finding. The Court did so by cherry picking holdings from *Avrahami* and misapplying them without factual support to *Reserve*.

Among the most striking examples is that the Court complained of the policies being marked "excess" (deliberately obfuscating the meaning of such) even though the policies' terms *on their face* did not require any underlying commercial coverages to be in place and where the uncontroverted evidence is that there were no underlying coverages. The Court ignored express policy language where the term "excess" provided that *only if there were other insurance in place* – which was not the case in any of the years at issue – would Reserve's policies provide secondary coverage. Otherwise, Reserve's coverages were primary. The Court excised the limiting language (see bolded portion below) and substituted ellipsis in the Opinion for the omission. In fact, each policy provided as follows:

THE COVERAGES AFFORDED BY THIS POLICY ARE EXCESS OVER ANY OTHER VALID AND COLLECTIBLE INSURANCE POLICY ISSUED BY ANY OTHER INSURER \* \* \*. THE LIMITS AND DEDUCTIBLES STATED HEREIN ONLY APPLY AFTER COVERAGE IS EXHAUSTED FROM ANY AND ALL OTHER VALID INSURANCE POLICIES ISSUED BY ANY OTHER INSURER.<sup>72</sup>

\* \*

THIS EXCESS POLICY DOES NOT REQUIRE THE INSURED TO MAINTAIN ANY SPECIFIC UNDERLYING PRIMARY INSURANCE POLICIES UNLESS SPECIFIED BY ENDORSEMENT TO THIS POLICY. **THE COVERAGES AFFORDED HEREIN WILL DROP DOWN AND PROVIDE COVERAGE ONLY IF THERE ARE NO OTHER VALID AND COLLECTIBLE INSURANCE POLICIES IN FORCE TO WHICH A CLAIM WOULD APPLY, SUBJECT TO THIS POLICY'S TERMS AND CONDITIONS.** (emphasis added).<sup>73</sup>

In contrast with the above express provisions that were included in the direct written policies, the Court erroneously suggested that there were underlying or overlapping commercial coverages – which there were not – and that Reserve's policies were erroneously priced.<sup>74</sup> The Court's position was not even argued at trial, nor was this even the subject of any testimony or briefing. The Court created this issue on its own, ignoring the clear contractual language. No issue of duplicative coverage was raised by the IRS in briefing or at trial.

Further, the Court’s implication of mispricing created by the “excess” concept (whose source was *Avrahami*) was contrary to the Court’s holding that “Capstone calculated Reserve’s premiums using objective criteria and what appear to be actuarial methods.”<sup>75</sup> In raising this issue *sua sponte*, the Court misconstrued as a matter of law a common insurance provision that otherwise “excess” policies may “drop down” and serve as primary coverage in the absence of underlying coverage.

This creative interpretation occurred in the face of the government’s sole expert witness admitting that at least 11 of the 14 policies of insurance were policies of insurance (in whole or in part), subject only to the question of pricing ***for which the government’s sole expert expressly acknowledged was not part of his opinion.***<sup>76</sup> The Court however rejected this admission in keeping with its shoehorning of *Reserve* into the *Avrahami* case, the facts notwithstanding. The Court seized on this non-contested issue – indeed the government admitted the very issue rejected by the Court – and made erroneous conclusions, without explaining the basis for its ruling.

### **Reserve’s Administrative and Professional Team**

Reserve operated its captive insurer drawing on an experienced team. Zumbaum testified that he relied on his advisors to carry out Reserve’s functions.<sup>77</sup> Each of Reserve’s direct written policies was selected and underwritten by it based on input from an on-site review of the insureds’ facilities by a CPCU, with Willis co-authoring the feasibility study, examined against a backdrop of the insureds’ commercial coverages and an examination of the insureds’ business operations conducted by credentialed insurance professionals working as members of a professional captive management team assembled by Reserve’s captive management firm, Capstone Associated Services, Ltd. (“Capstone”). This is in addition to the Peak insureds’ testimony of further input on policies from its commercial insurance advisors. Multiple persons, including CPCUs, actuaries, CPAs, and other insurance professionals were involved in advising Reserve throughout its life.<sup>78</sup> However, the Court concluded that this was somehow improper because Reserve’s president did not appear to know enough about Reserve’s insurance matters even when he drew from a broad team of advisors.<sup>79</sup>

Despite the Court’s view to the contrary, the business principal isn’t the person who is responsible for independently operating the arrangement. The Peak insureds formed a team – including Capstone, CPAs, attorneys, actuaries, commercial insurance brokers, and regulators – to provide a range of captive services supporting the insurance arrangement. The Court criticized the owner of the insureds for not undertaking the work on its own and for not performing sufficient “due diligence,” brushing aside that Reserve engaged its captive advisory team to do just that with respect to both the underwriting of its direct policies and Reserve’s participation in the pooling arrangement that was administered by PoolRe.<sup>80</sup> Despite the Court’s reluctance to analyze the evidence before it, the joint feasibility study issued by [Willis](#) (the world’s third largest insurance and risk management organization) and Capstone to Peak, as a prospective insured, stated as follows:

***“The captive’s risk diversification efforts will be handled predominantly through***

***coverage design, through participation in an insurance pooling of similar policies among unrelated companies and through the reinsurance assumption of unrelated business, most of which is expected to be co-arranged and co-administered by Capstone. In addition, the proposed insured expects Capstone to help ensure improved service over conventional insurers, increase control of its risk management program, and to enhance its overall risk management perspective.”<sup>81</sup>***

This is exactly what then happened. However, the Court brushed aside Reserve’s engaging a professional team and its reliance on such. The Court’s reasoning is similar to requiring a hospital patient to fully articulate his doctor’s medical treatment as a condition of recognizing a medical expense deduction or claiming an insurance reimbursement. By analogy, if the patient can’t satisfactorily explain his treatment plan to the IRS, it’s not insurable.

The collection of information in the on-site examination of the insureds was completed in advance of the formation of Reserve and in advance of Reserve issuing policies.<sup>82</sup> The on-site examination culminated in the issuance of a final, detailed written feasibility study that was coauthored and jointly issued to the insureds by both [Capstone](#) and [Willis](#).<sup>83</sup> The Court was critical of the fact that the final version of the feasibility study was not issued until after the captive was formed, although the onsite examination was conducted in advance of Reserve’s formation and in advance of Reserve issuing policies (indeed in advance of Reserve’s regulatory application for formation).<sup>84</sup> The uncontroverted evidence at trial established that a draft of the feasibility study was circulated to the insureds and Reserve’s proposed owners before the captive was formed,<sup>85</sup> which was relied upon by the participants in Reserve’s insurance transactions. Despite the Opinion’s complaints, at trial, the government never made any argument that the feasibility study was either insufficient or untimely. Nonetheless, the Court misconstrued the uncontroverted testimony and imposed a creative timeline, implying in the Opinion (contrary to the uncontested evidence before it) that the information from the feasibility study was not in the hands of the Peak prospective insureds owners until well after Reserve’s formation.<sup>86</sup>

The Court was also unexplainedly critical of the fact that Reserve’s insurance underwriters continued to maintain their files with updated financial, insurance and operational information on the insureds in support of Reserve’s ongoing underwriting activities in later years, wrongly implying that Reserve did not possess such information prior to Reserve’s 2008 formation.<sup>87</sup>

As discussed below, the Court’s critique of Reserve’s captive management team was not consistent with the evidence presented at trial.

First, the Court stated that the feasibility study (prepared jointly by Capstone and Willis) “did not provide detailed information regarding the other risks that conventional insurance might not cover.”<sup>88</sup> In point of fact, there was no discussion at trial as to an “accepted” or industry standard format for a feasibility study or even the requirement for a feasibility study in the first instance, which was confirmed in an article written by the government’s sole expert witness discussing whether a captive feasibility study is necessary.<sup>89</sup> No such standard was even suggested at trial because such doesn’t exist. The Court erred in imposing newly created requirements for a feasibility study and then concluding its heightened bar had not been satisfied.<sup>90</sup> The Court’s position was clearly erroneous and went outside the trial record.

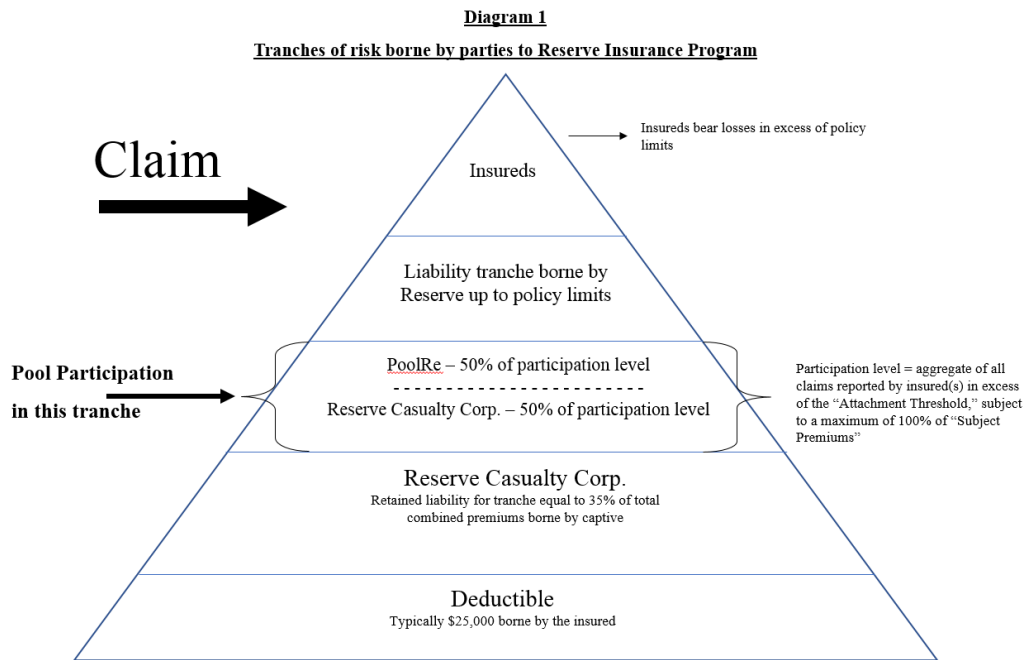
Further, even a brief review of the trial record controverts the Court's own "analysis." The feasibility study contained over 10 pages (1) analyzing each of Peak's then existing commercial insurance coverages, (2) describing the coverage issues and concerns typically faced by similar insureds due to shortcomings in commercial policies, (3) discussing other issues (such as pricing inequity, market conditions, loss control, and risk management issues) not typically addressed by commercial policies, and (4) identifying and explaining eight different exposures that Reserve might consider insuring through a captive insurer.<sup>91</sup> Despite the lack of any evidence or testimony on what a feasibility study must or should contain, the Court manufactured its own conclusions as to what it thought should be included, conducting no analysis of the evidence or the testimony at trial or even an accurate review as to what was done prior to the decision being made to form a captive.

Second, the Court suggested, again erroneously, that the role of Willis was limited to a high-level review of the study and that the Willis senior vice president doing the work, Robert Snyder, was not closely involved in the preparation of the feasibility study.<sup>92</sup> Contrary to the Court's implication, Mr. Snyder testified at trial that he worked on a collaborative basis with Capstone's staff over a long period of time and that it was his ongoing role to review assembled background material in the context of the preparation of feasibility studies, leading to such studies being jointly issued by Willis and Capstone.<sup>93</sup> Without any basis for such, the Court concluded that Mr. Snyder was simply "rubber stamping" the feasibility study.<sup>94</sup> In point of fact, Willis offered its professional opinion and signed the study, with Capstone taking joint responsibility for such, all of which was uncontroverted at trial.<sup>95</sup> The Court's liberty with the testimony cannot be explained.

In any event, the feasibility study represented the joint work product of the two organizations, which both stood by the report at trial. The information gathered from the insureds was analyzed by both organizations' representatives, followed by meetings and discussions taking place between Messrs. Snyder and McNeel, culminating in the feasibility study being jointly issued under the authority of both companies who performed the work as a collaborative effort.<sup>96</sup> Yet the Court concluded that this approach was unacceptable.<sup>97</sup>

### **The Pooling Arrangement**

Each of the above direct written policies for the three named insureds were directly underwritten by Reserve jointly with PoolRe, which issued a stop loss endorsement on each policy for a separately stated premium (depending on the year and based upon an independent actuary's input) of between 18.5% and 19.9% of the total direct written premiums accepted by the pool. That is, if a Reserve issued policy were for \$1 million in face value coverage, the PoolRe stop loss endorsement provided that above a certain threshold of loss through a given payment cap that such loss tranche would be 50% paid through PoolRe (which had separately distributed its liability among 58 other insurers for which PoolRe administered claims). This traditional insurance pooling arrangement has as one of its objectives limiting Reserve's exposure for a large loss that could impair Reserve's viability in the case of a larger claim. The following diagram depicts the different tranches of risk that were borne by each party in connection with Reserve's participation in the PoolRe pooling arrangement (in 2010, for example).



From the standpoint of PoolRe, its businesses include operating a pooling arrangement in exchange for receiving premiums, with PoolRe blending the risks of all participants and then novating these rights through a quota share agreement such that the homogenized premiums for the many hundreds of policies are ceded to dozens of reinsurers for a premium paid to them. These other insurers absorb on a pooled or homogenized basis what was formerly PoolRe's risks and prior to that the risks of (in 2010) 650+ otherwise unaffiliated insureds.

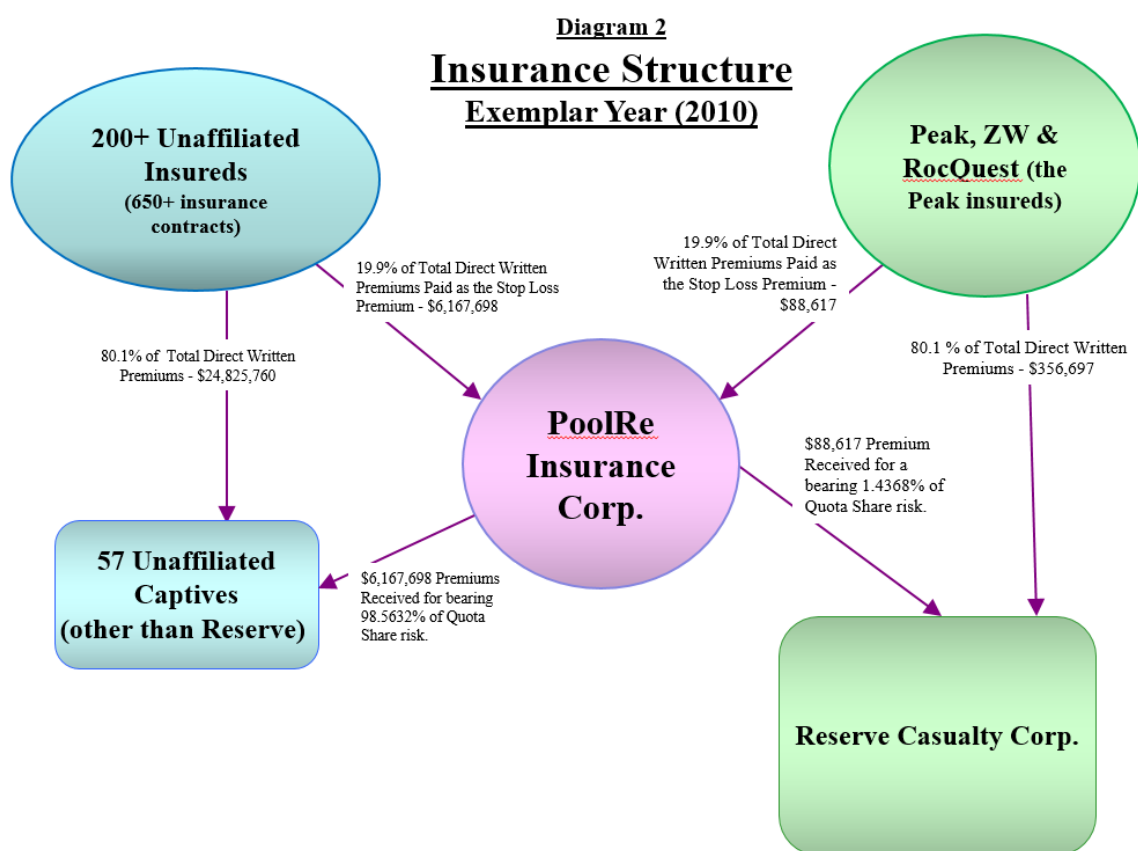
The pooling structure follows an industry recognized design and was the subject of uncontroverted testimony of Snyder and Doherty, among others.<sup>98</sup> Underpinning the stop loss endorsement was a pricing report provided by a credentialed Fellow of the Casualty Actuarial Society (FCAS) and member of the American Academy of Actuaries, as set out by unchallenged documentary evidence presented at trial.<sup>99</sup> The stop loss endorsement and quota share program protected Reserve against fortuitous risks for a given monetary tranche, as explained in the feasibility study.<sup>100</sup> Just as a commercial carrier would limit its risk relative to its capitalization to large losses, in a similar manner, the stop loss endorsement served the same purposes on behalf of Reserve. At the same time, the quota share program provided risk diversification to its insurance portfolio. More importantly, there was no evidence presented by the government at trial to controvert the testimony offered by the Wharton School's Dr. Neil Doherty and Willis' Robert Snyder, who explained that PoolRe's pooling arrangement is an industry standard program.<sup>101</sup>

All of Reserve's direct written policies were bound only after its underwriter had the benefit of an on-site inspection of the insureds' principal facilities in Osborn, Idaho, debriefed the insureds, examined loss histories and commercial coverages and, of course, only after Reserve had been formed and was fully licensed in its domicile.<sup>102</sup> All 58 unrelated captive insurers participating in the PoolRe administered stop loss and quota share agreements went through similar



underwriting requirements prior to being admitted by PoolRe as pool participants as was the subject of McNeel's testimony.<sup>103</sup>

PoolRe operated an industry standard pooling arrangement for the mutual benefit of hundreds of stop loss insureds (e.g., more than 200 insureds in 2010) for each year at issue.<sup>104</sup> Under this arrangement, PoolRe's stop loss endorsements on over 650 stop loss insurance policies (in 2010) were reinsured (retroceded) for a premium paid by PoolRe to each of 58 participating reinsurers (in 2010), with these participating captives being retroceded insurers which novated PoolRe's theretofore risks. PoolRe administered the pool and held many millions of dollars in retention for loss expenses.<sup>105</sup> The following diagram depicts the structure of the 2010 pooling arrangement as it related to Reserve, the Peak insureds, and many unaffiliated insureds and captives, showing the premiums exchanged by the relevant parties.



Although no legal requirement exists in any jurisdiction or under U.S. tax law for a pool to be a licensed insurer or for the pool to function through the issuance of "insurance policies" (as opposed to functioning as a non-insurance, but contractual, risk sharing arrangement), PoolRe in fact was a long-standing licensed insurer under the laws of the British Overseas Territory of Anguilla. The uncontroverted evidence at trial was that Anguilla's laws were of a similar rigor to that of, by way of example, Delaware. Two witnesses testified to the fact that PoolRe was an insurance company licensed by a territory of the United Kingdom during all years at issue.<sup>106</sup>

No witness ever controverted such. Despite no challenge as to PoolRe being a UK-territory licensed insurer for all years at issue, the Court *sua sponte* held that only two years of actual, physical licenses were “in evidence” in rejecting the otherwise uncontroverted and unchallenged at trial as to PoolRe’s licensing and regulation for the years at issue (2008 - 2010).<sup>107</sup>

Despite a lack of contravening testimony – for example, no expert including not even the government’s sole expert testified – that PoolRe was anything but a licensed insurance company for all years at issue – the Court concluded *sua sponte* without jurisdiction over non-party PoolRe that it was not an insurance company under U.S. tax law,<sup>108</sup> while also concluding not only without precedent (except for *Avrahami*) but also contrary to the existing precedent, that a pooling arrangement had to be done as an insurance arrangement and within a bona fide insurance company for U.S. tax law.<sup>109</sup> Not surprisingly, the Court could not cite to another basis for its newly created position and could not cite to evidence from the *Reserve* trial because this was not even a contested issue.

Among the reasons that PoolRe’s status as a “bona fide insurance company” for tax purposes was not an issue at trial was that, as explained above, as of the date of the *Reserve* trial, no precedent existed for applying this requisite to a pooling arrangement<sup>110</sup> and solid precedent existed to the contrary.

The Court’s holding requiring a pooling arrangement to be recognized as a “bona fide insurance company” for tax purposes tracks the erroneous legal standard first introduced in August 2017 in *Avrahami*, which was decided more than three months *after* the trial in the *Reserve* trial concluded. ***This issue is discussed in this commentary beginning at page 26.*** There was no testimony or analysis supporting these positions calling for a pooling arrangement to be carried out by an insurer, which not only went beyond the trial record in *Reserve* but implicitly determined that decades of insurance industry practice continuing to this day are erroneous. The Court appeared determined to shoehorn *Reserve* into the *Avrahami* case without regard to the evidence presented, the issues in dispute or existing law.

### **Evidentiary Issues – The Court’s Unsupported Factual Findings**

There are numerous factual conclusions reached by the Court in *Reserve* with respect to issues for which the government **offered no controverting evidence or testimony** that disputed or challenged the evidence or testimony that was presented by Reserve. Further, the Court reached conclusions adverse to Reserve on “controlling” issues that were never raised by either party at trial. In the context of the *Reserve* case, the testimony of the 10 witnesses for Reserve (seven witnesses accepted by the Court as experts and three as fact witnesses) was largely uncontested, with the government calling only one expert witness, ***whose testimony was limited in scope to a narrow range of issues.***<sup>111</sup>

### **The Court Did Not Respect the Proof Offered and Made Findings *Sua Sponte* on Uncontested and Uncontroverted Issues**

The Court frequently ***went outside the record.*** By way of example, it did so with respect to the following:

- No credible expert or fact witnesses testified on behalf of the government that there was any lack of need for pollution liability coverage for Peak or the other insureds. The corporate representative for the insureds testified that the insureds had sought pollution liability insurance from commercial carriers but that understandably such was not available, given Peak's being located within a Superfund Site and the nature of its business.<sup>112</sup> The Court *sua sponte* concluded that the insureds had no "business purpose" to acquire pollution liability insurance or any of the other coverages.<sup>113</sup>
- The government did not cite even once to its sole expert witness by name or by testimony in the whole of its post-trial briefing for the apparent reason that the government's expert had been largely discredited on the stand as his testimony reflected numerous instances of backpedaling. "Expert" Riggin admitted on cross-examination that statements in his testimony and expert report were inaccurate.<sup>114</sup> Likewise, the **Court** did not cite even once by name or reference to this expert witness' testimony. What was unusual in this case was that neither the Court nor the government addressed the government's sole expert after his testimony was largely debunked at trial. Rather, the Court's analysis was based on the Court going outside the record and drawing on whatever other experience it had, if any, with insurance matters.<sup>115</sup>
- The government's expert witness admitted that at least 11 of the 14 policies (9 in whole and 2 at least in part) issued by Reserve were "insurance" if analytically based premiums could be established for such policies.<sup>116</sup> The Court concluded that Reserve's premiums were priced "using objective criteria and what appears to be actuarial methods."<sup>117</sup> Further, the government's witness specifically said he was not testifying on pricing.<sup>118</sup> And multiple witnesses, including two different actuaries, testified in support of Reserve's policy pricing.<sup>119</sup> Nevertheless, the Court rejected in total all of Reserve's policies as not being insurance with scant analysis,<sup>120</sup> as well as rejecting Reserve's entire insurance arrangement – all several hundred policies underwritten by Reserve with non-affiliates and the reinsurance Reserve assumed from the commercial markets – in concluding that no insurance existed anywhere at any time whatsoever for any of Reserve's underwritten policies. The Court went outside the record in developing facts and new theories that were never tried.
- There was no evidence offered by the government to assert that any of the commercial policies underwritten by the insured's commercial insurers duplicated the policies issued by Reserve. Yet the Court, *sua sponte*, cited to the following in concluding that Reserve's policies were not policies of insurance: (1) that Reserve's direct policies contained language that they were "excess" to the commercial policies (even though such policies by their express terms were not duplicative with any commercial policies),<sup>121</sup> discussed above, and (2) that Peak had not previously exhausted the policy limits of its commercial insurance coverages.<sup>122</sup> Neither the government nor any witness made these arguments, which are unsupported by the evidence and were not issues at trial. The Opinion manipulated the policy language and then arrived at an erroneous conclusion.
- There was also no evidence or testimony offered by the government to suggest that the policies issued by Reserve were remote from the risks of Peak and the other insureds or to

suggest that Peak did not have a legitimate need for acquiring each of Reserve's direct issued policies based on the risks that were specifically identified in Peak's feasibility study. For example, this was not the case of an errant marine cargo policy being issued for a company not engaged in shipping. Yet the Court, *sua sponte*, stated that it did not view the policies that were issued to Peak by Reserve as having a "genuine need" or "legitimate business purpose" all without any support other than the Court's summary statement to this effect.<sup>123</sup> Again, the Court created matters of controversy on issues not tried by the parties that even the government considered to be non-issues. The Court not only created the issue but then found in favor of the respondent.

- The Court did not attempt to reconcile – because it couldn't – its perceived lack of a "genuine need for acquiring additional insurance" with the fact that one of the direct written insurance policies purchased from Reserve by Peak resulted in a \$339,820 claims payment by the captive to the insured to cover actual losses suffered as a result of the loss of a major customer. Nor did the Court explain the \$187,891.99 in losses paid by Reserve to Lyndon's insureds which the Court called "de minimis".
- Although neither PoolRe nor any of the ceding entities of the reinsurance assumed nor the underlying policies issued by a publicly held commercial carrier (Lyndon) was before the Court, the Court took fault with this industry standard reinsurance (ceding) arrangement.<sup>124</sup> The Court cited no authority for the ceding arrangement being deficient and appeared to confuse the ceding reinsurance arrangement as being facultative reinsurance (rather than treaty insurance), faulting Reserve for not putting into evidence Lyndon's 100,000+ underlying policies.<sup>125</sup> There was no evidence presented by the government at trial to even suggest that this third-party insurance was not insurance for federal income tax purposes, rejecting without citation or explanation, the uncontroverted testimony of actuary Gary Fagg. Nonetheless, the Court rejected such as insurance.
- The Court erroneously imposed on Reserve an "arm's-length" standard for insurance policies written to its affiliated insureds and concluded that the absence of a premium being negotiated at "arm's-length" negated Reserve's policies from qualifying as insurance for federal income tax purposes. The Court did not consider the prove-up of premium income being based on pricing indications that Reserve received from a regional third-party insurance brokerage,<sup>126</sup> consistent with the principles for determining arm's-length equivalent pricing between affiliated entities under IRC Section 482, even when such was further supported by actuarial reports. Rather, the Court ruled that, in the absence of insurance premiums being charged at "arm's length" (negating any related party transactions) that pricing "defects" were fatal, thus rejecting on a wholesale basis all of Reserve's captive insurance arrangements.<sup>127</sup> In doing so, the Court rejected multiple alternatives afforded the government under IRC Section 482 for calculating pricing for transactions between related parties, any one of which should resolve the Court's objections.
- In addition, the Court seems to have contradicted its own finding that "Capstone calculated Reserve's premiums using objective criteria and what appear to be actuarial methods."<sup>128</sup> The Court has now set out its position – despite the pricing methodologies presented by the four actuaries and the regional insurance brokerage – that no captive insurers may exist

because pricing is (by definition) not at “arm’s length,” all with the understanding that the Court made up pricing as a controverted issue given that the government declined to provide any controverting evidence on pricing and the Court’s reluctant conclusion at page 61 of the Opinion that the pricing was acceptable based on the overwhelming pricing evidence at trial.

### **New Concepts Introduced by This Court on Insurance Policy Selection and Related Issues**

In its Opinion, the Court created new factual and legal concepts not seen in the years of insurance case law while not even citing beyond *Avrahami* to precedent for most of its shoehorned findings. Yet, *Reserve* was issued as an unpublished tax memorandum opinion, which is typically reserved for decisions that *do not involve novel legal issues for which the law is settled or for which the result is factually driven*.<sup>129</sup> *Avrahami* was not appealed following the issuance of its August 2017 opinion.

These newly established concepts were generally not even the subject of witness testimony during the trial. The Court apparently made its findings *sua sponte*, drawing on its own “experiences” on each of the concepts discussed below.

#### **A. Insurer Must Show an Insured’s “Business Purpose” for a Policy to be Considered Insurance**

The Tax Court has established a new “high bar” standard that it views as needing to be satisfied by an insurer. According to this Court, for an insurer to underwrite a policy that is recognized as insurance for tax purposes, the **insurer** must **first properly conclude the existence of a legitimate “business purpose” of the insured** for acquiring the policy.<sup>130</sup> And it appears that what constitutes a legitimate “business purpose” to this Court will always be out of reach.

As discussed above, to demonstrate to this Court a valid business purpose for acquiring insurance, it is not even enough that an insured is physically located on a Superfund tract whose business involves contaminated equipment to have pollution liability coverage, by way of example, even where the commercial markets have declined coverage.<sup>131</sup> It is not enough that the insured wishes coverage against a loss of a major customer even where such policy paid out a claim a year later in the amount of \$339,820, as was done by *Reserve*.<sup>132</sup> Whatever the bar is, the words has been posted so high and so small that the requirements can’t be read.

That is, as the trial court would have it, by way of example, AIG must make inquiry of an insured as to why the insured wants a commercial general liability policy, a business interruption policy or a pollution liability policy before issuing such a policy. No business purpose is found to exist in the absence of an **insurer** having satisfactory support for the business purpose of its **insureds** that would satisfy a tax court’s review years later as to the insureds “genuine need”<sup>133</sup> for the policy in question, being a newly articulated tax standard. If the Court “determines” that there was ***not*** a “genuine need” for the insurance, the insurer is deemed not to be an insurer for federal income tax purposes. The Court has set the bar so high as to conclude that a company located in a Superfund site cannot obtain pollution liability insurance and that a company can’t insure against the occurrence of fortuitous events that might lead to a loss of a significant customer.

The above “analysis” of the Court may be examined in light of the fact that each of the policies issued by Reserve was individually priced by a professional and credentialed insurance underwriter following an onsite inspection of the premises and operations.<sup>134</sup> The pricing procedures of the underwriter took into account individual factors of the insureds, individual insureds’ premium indications (received from Mid-Continent General Agency, Inc., an agency able to bind Lloyd’s of London),<sup>135</sup> the applicable policy limit, the exposure basis (e.g., the insured’s revenue or headcount), an increase limit factor, and the policies’ terms and conditions.<sup>136</sup> The underwriter’s pricing was supported by the overwhelming evidence from three separate actuarial organizations.<sup>137</sup> Before the planning was undertaken, the underwriter had the benefit of Willis’ independent review, joined in by Capstone, in a written feasibility study, unchallenged by the respondent, with the Court concluding that the premiums charged by Reserve were determined “using objective criteria and what appears to be actuarial methods.”<sup>138</sup> This followed the lack of contravening evidence from the government’s sole expert who affirmatively declined to provide any evidence on policy pricing or actuarial issues generally.<sup>139</sup> Nonetheless, the Court concluded 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.”<sup>140</sup> In its attempt to justify its finding that Reserve’s policies lacked a legitimate business purpose, the Court erroneously found that Peak did not have a “genuine need” for acquiring the direct written policies from Reserve.<sup>141</sup> The extensive evidence presented cannot be reconciled with the Court’s conclusion as to business purpose, or with the Court’s holding that the policies’ pricing was determined “using objective criteria and what appears to be actuarial methods.” Nor can the Court’s holding be reconciled with the \$339,820 claim that was paid by Reserve to its insured for a loss under one of Reserve’s policies. Nor can the Court’s holding be reconciled with Reserve’s having paid \$56,399.81 in losses to third parties in 2010 alone.<sup>142</sup>

The Court’s Opinion focused on the August 2009 delivery date of the *final, executed and fully reviewed* feasibility study, being about 9 months after the beginning of Reserve’s operations.<sup>143</sup> The Court focused on this fact despite its acknowledging that the onsite visit of Peak’s facilities by the CPCU underwriter, whereby information was gathered and Peak’s operations were examined, analyzed in detail and reported on to the Peak insureds, in August 2008, *prior to* even the application to form the insurer being submitted to the insurance domicile’s regulator. The Court also ignored that a draft of the feasibility study was provided to Peak and its owners for comment in September 2008, soon after the onsite visit was completed and prior to the decision to proceed with forming the captive.<sup>144</sup> The Court also erroneously complained about the management team continuing to update its underwriting files throughout the life of the captive with information in furtherance of its duties, as somehow being evidence that the feasibility study was not performed prior to Reserve’s formation.<sup>145</sup> All of this was raised *sua sponte* by the Court, without any evidence presented or even allegations by the government regarding the timeliness or sufficiency of the information that the captive manager evaluated in connection with arranging for the feasibility study.

Among its surprises is the Court’s own subjective analysis concluding that the Peak insureds did not need to buy pollution liability coverage because the Court “concluded” that Peak had sufficient practices in place to protect against pollution liability.<sup>146</sup> The Court’s “basis” for this

“conclusion” was nowhere to be found in the record below. Would the Court also conclude that Exxon had sufficient preventative measures in place to negate the “need” for pollution coverage before the *Valdez* or for BP before the Macondo disaster? In any event, the basis for the Court’s re-interpretation of a “fortuitous loss” is nowhere to be found at trial.

The Court also cast aside Reserve’s pollution liability policy’s coverage under the Comprehensive Environmental Response, Compensation, and Liability Act of 1980 (“CERCLA”)<sup>147</sup> wherein a person may be compelled by the EPA to clean up a site or undertake an environmental cleanup or be assessed the cleanup costs. Despite Reserve including a detailed description in its opening brief describing Peak’s Superfund liability exposure,<sup>148</sup> the Court incorrectly concluded that Superfund site landowners do not face a fortuitous risk of pollution liability loss.<sup>149</sup>

How can the Court get it so wrong? The Court’s misunderstanding of CERCLA may have been lifted from the testimony of government’s expert witness, Donald Riggin, who inarticulately stated that it was his “understanding” that a business located in a Superfund site would “[be] immune from liability if [the business is] in a Superfund site.”<sup>150</sup> Mr. Riggin further stated that “You could have liability but under the Superfund rules you do not have liability, it is a Superfund site, everything that occurs on the Superfund site is part and parcel of that environment.”<sup>151</sup> When Mr. Riggin was asked on cross-examination if he knew why the EPA regulates a Superfund site, he simply responded “I do not know.”<sup>152</sup> This response evidenced Mr. Riggin’s utter lack of knowledge, despite Mr. Riggin being offered as an “insurance industry expert” by the government at trial.<sup>153</sup> Nonetheless, it appears that the Court may have adopted Mr. Riggin’s “no liability” assertion in concluding that Reserve’s issuance of a pollution liability policy was erroneous, as evidence of the Court’s lack of understanding of the strict liability imposed under CERCLA.

To the contrary of the above offered testimony and as set forth in Reserve’s briefing,<sup>154</sup> under CERCLA, landowners and lessees, among other parties, may be liable for the contamination or misuse of property while under the control of another. Four different classes of potentially responsible parties (PRPs) may be held liable for contamination at a Superfund site.<sup>155</sup> Yet, the Court reached an erroneous conclusion on its own, without the benefit of either testimony or argument that Peak “already had systems in place to control the fluid runoff when it cleaned equipment used in polluted mines.” Given the broad potential reach of CERCLA and the fact that Peak was physically located in a Superfund site, with the property’s exposure exacerbated by its work on contaminated equipment brought there from offsite contaminated mines where the Peak insureds worked, the Court was clearly erroneous in concluding that the Peak insureds did not have a fortuitous risk of pollution liability, resulting in its desire to insure such. Furthermore, the Court lacked any basis for concluding, by way of example, that the Peak insureds had reasonable procedures in place so as to limit liability. The Court substituted its own business, scientific and engineering judgment for that of the insureds in its finding that there was not a “genuine need” for pollution liability coverage.<sup>156</sup>

According to this Court, a subsequent inquiry may be made for each policy wherein, if a court views (regardless of the lack of testimony) the risks as not being sufficient (e.g., there’s not pollution liability risk in the Court’s later articulated view), the Court can deem the arrangement

not to be insurance. This is all despite there being no commercial pollution policy in place, the unchallenged testimony at trial that commercial insurance coverage was unavailable to the insureds in the marketplace given their location on a polluted tract within a Superfund site, and the desire of the Peak insureds to have such coverage,<sup>157</sup> all while there was no duplication with the insureds' commercial policies. The unsupported conclusions of the Court stand in sharp contrast with the lack of any evidence offered by the government to challenge the need for these or other coverages.

In fact, as set forth above, the government's sole expert witness conceded that, subject to the taxpayer carrying its burden on pricing, that at least 11 of the 14 policies – including the pollution liability policy – were policies of insurance. However, in the Court's contrary view and with limited analysis, none of the issued insurance coverages were warranted, causing the Court to hold that Reserve did not qualify as an insurance company for federal income tax purposes.

The Court appears to have injected into the analysis of what type of policies that an *insurance company* can issue an inquiry into the reasons why its customer, **the insured**, is buying the policy. The fact that Reserve's insurance policies on their face were matched to the nature of the insureds' business and risks, as identified in Peak's feasibility study and testimony, would seem to end an inquiry into why Peak would buy certain policies from Reserve.<sup>158</sup> Since Peak provides, operates and services equipment 8,000 feet underground, operates in polluted and contaminated environments, and is physically located on and in a Superfund site, and has a finite number of large customers, Peak's need for insurance coverages beyond the auto liability and related plain vanilla commercial coverages originally present, should be self-evident, with the Court's conclusion to the contrary being clearly erroneous.

Absent from both the Court's and the government's analysis is why \$339,820 in payments to the Peak insureds (and \$187,891.99 in additional payments to unaffiliated insureds) were made, if not for insurance losses. The Court was unmoved as to the business purpose of the insurance arrangement despite these significant pay-outs by Reserve. To this Court, the payment of this direct written claim to an affiliate and payment of losses to non-affiliates did not indicate that there was a valid business purpose for the insurance arrangement.

What more direct evidence can a court demand to show a valid business purpose beyond showing the payment of a claim made under a policy to an insured (Peak) by the insurer (Reserve) for a covered loss?

Ultimately, the Court established a new standard in the Opinion that now requires an insurer to demonstrate that its insureds have a valid "business purpose" satisfactory to the Court for acquiring a given insurance policy from an affiliated insurer. Oddly, the Court did not feel constrained by the jurisdictional posture of the case in that the business purpose of the non-party insureds was being adjudicated.

After imposing a business purpose requirement on a "for-profit" insurer to inquire into the business purpose of its insureds, the Court then ignored the evidence that was presented at trial, including the testimony of Reserve's and Peak's 50% owner<sup>159</sup> in combination with the



testimony of Reserve's expert witnesses regarding Peak's need for acquiring *each of the direct written coverages*, among which was the testimony of experts Robert Snyder<sup>160</sup> and Dr. Neil Doherty.<sup>161</sup> The Court substituted its own subjective business judgment developed outside the record for that of the businesses' owners in finding that Peak did not have a "genuine need" for acquiring insurance coverages to protect against fortuitous risks identified in the feasibility study that were present in operating its business. This is all despite the government not offering any evidence or testimony at trial that would support the Court's findings that Peak did not have a legitimate need for each of Reserve's direct written policies. The Court was clearly erroneous in its findings.

The Court also rejected the third-party reinsurance ceded to Reserve from Lyndon through PoolRe in its finding of no valid business purpose, concluding that such was not insurance despite the uncontroverted expert testimony from actuary Gary Fagg, who described both the underlying Lyndon insurance policies and the specific details of Reserve's third-party reinsurance arrangement.<sup>162</sup> Again, in doing so the Court undertook no analysis whatsoever. The business purpose of Reserve in assuming this third-party reinsurance was to further distribute its risks by assuming a portion of the risks of many thousands of unrelated insureds under the reinsurance agreement.<sup>163</sup> This reasoning was presented at trial and left uncontroverted by "expert" Riggin but nonetheless rejected by the Court. Yet, risk distribution is a fundamental pillar of insurance which Reserve satisfied in part through insuring the many thousands of unaffiliated policy holders. The Court's conclusion that Reserve did not assume "insurance" from Lyndon is subject to a *de novo* standard of review as a legal issue or a mixed question of fact and law. These third-party risks, which were originally underwritten by an unaffiliated publicly-held commercial insurer, were not only dismissed by the Court as not supporting the business purpose of Reserve, but the Court also arbitrarily and summarily concluded, without any analysis, that this unaffiliated third party insurance was not "insurance" for tax purposes.<sup>164</sup> The Court did not feel compelled to conduct any analysis for this extraordinary position taken against a non-party. The fact that substantial losses were paid under this third-party arrangement was not addressed by the Court. Nor explained was the Court's characterization of the third-party arrangement as "de minimis" despite \$187,891.99 of losses being paid by Reserve to unaffiliated parties over the three years at issue.

#### B. Insureds Must Show Previous Actual Loss History for a Policy to be Insurance

The Court announced other groundbreaking prerequisites for insurance to be found for tax purposes. The Court stated (or at least strongly implied) that an **actual loss history of the insured** must be shown in the particular area of coverage as a prerequisite *for the insurer* to recognize a contract as an insurance policy.<sup>165</sup> As with its other newly announced positions, the Court cited to no authority. Apparently, the insurer's role is to discern that historical losses exist in an area of coverage before a policy covering the same can be issued, but not find so many losses as to undercut the profit motive of the insurer or to limit the insureds' ability to obtain coverage for a risk that has a high risk of prospective losses. The bar being set by the Court is indiscernible. This newly articulated concept contrasts with long established law that insurance is to cover a fortuitous risk of future losses.

In the case of Reserve, the Court held that the policy being issued was for pollution liability with respect to an insured located in a designed Superfund Site, where contaminated equipment originating from mines which also were contaminated, was repaired and rehabbed, was *insufficient* evidence for the pollution liability contract issued by Reserve to be considered insurance. The fact that the coverage extended to the property owner, RocQuest as one of the Peak insureds, as an additional named insured was similarly of no consequence. This does not bode well for a business wishing to insure against fire (does the physical plant have to first burn down?) or against the death or disability of a key person (does the measured life have to die or become disabled before the policy can be purchased), making the result unachievable.

Among the other policies issued by Reserve to Peak was a policy to insure against the loss of a major customer. Such a loss actually occurred to Peak within the first year of Reserve's operations. The Court held that Reserve's paying a \$339,820 payment on a claim – apparently because a similar loss hadn't previously been reported – also was not sufficient for the policy issued by Reserve to be considered “insurance”. See also July 9, 2018 Commentary on Policy Pricing, which can be found [here](#).

Each of the policies directly underwritten by Reserve covered risks directly related to Peak's business. For example, the Regulatory Changes policy covered losses flowing from adverse changes in regulations. Because Peak's products were focused on the heavily regulated mining industry, Peak was at risk and directly affected by regulatory and legislative changes.

The Court also did not attempt to square this newly announced dictate of a history of past losses with the “fortuitous risk” of loss concept inherent in insurance that had been the focus of courts for decades.<sup>166</sup> The Court did not reconcile this concept of requiring an “actual loss history” with the settled concept (established by prior case law) that, once a loss is certain, a contract is not “insurance” due to the fact that the “fortuitousness” is no longer an issue.<sup>167</sup> Thus, apparently to this Court, a risk must have already occurred so as to create a history of losses, with the insurance then being written to cover future losses of a similar nature. Again, the Court provides no citation to case authority for this newly announced radical concept, requiring a captive insurer to thread a needle.

### C. Commercial Policies Must First Be Exhausted for a Policy to be Insurance

Another newly articulated yet unsupportable standard imposed by the *Reserve* Court is that, for an arrangement to be (captive) insurance for federal income tax purposes, **the insureds' commercial policies must first be exhausted**. The Court erroneously imposed this new standard on Reserve in the Opinion, stating at page 60 as follows:

“All the direct written policies [written by Reserve] included a provision that the coverage afforded by the policy would be valid only after insurance coverage from other insurers was exhausted. **Peak had never come close to exhausting the policy limits of its third-party commercial insurance coverage.**” (Emphasis Added).

As discussed above and in the Opinion, **none** of the policies jointly underwritten by Reserve and PoolRe were duplicative of any of Peak’s commercial third-party insurance coverages. Each of these direct written policies covered distinct risks from Peak’s commercially issued policies.

However, under the Court’s analysis, commercial insurers’ workers compensation and auto liability insurance policies must be exhausted before a “captive-issued” pollution policy or business interruption policy can be effective. The Court cited no authority for this extraordinary proposition.

The Court created this issue *sua sponte* even though this was never a contested issue at trial or in the history of insurance law. Perhaps the explanation for this is that the Court failed to understand the basic premise of insurance: coverage is contractual in nature, covering only what is specified. Based on such, a straightforward reading of this contractual term reveals that this provision resolves if there were overlapping or duplicate coverage – which was not the case in *Reserve* – which insurer bears the first risk of loss. Yet in the end, the Court imposed its own erroneous interpretation regarding the meaning of this contractual provision despite the parties never contesting the meaning of this provision throughout the trial and there being no briefing on such. In doing so, the Court again created its own new insurance taxation statutory scheme, ignoring dozens of cases over decades and even more decades of insurance practice.

Without having to read between the lines, this Court concluded in the case of *Reserve* that everything was bad and that nothing worked. The direct written insurance covering distinct and tailored policies for the risks being faced by the Peak insureds was bad. The 600+ pooled policies from over 200 unaffiliated companies – even without any examination of such – covering similar risks were bad. Even Reserve’s acceptance of ceded commercial reinsurance from a non-affiliated publicly-held insurer was bad.

The Court emphasized each of the above newly introduced concepts throughout the Opinion in reaching its conclusions that: (1) the purported reinsurance agreements between PoolRe and Reserve did not allow Reserve to effectively distribute risk<sup>168</sup> and (2) Reserve’s transactions were not insurance transactions in the commonly accepted sense.<sup>169</sup>

#### D. PoolRe Must be a “Bona Fide Insurance Company” – A Non-Contested Issue at Trial

In addition to each of the factual concepts discussed above that were introduced by the Court for the first time in *Reserve*, the Court ***retroactively applied a new legal standard*** to the PoolRe administered pooling arrangement based on a legal concept that was first introduced in the *Avrahami* case, decided both ***after the close of evidence in the Reserve trial*** and after the filing of the post-trial opening briefs by both Reserve and the government.<sup>170</sup> As discussed below, the *Avrahami* court was wrong in its holding onto which the *Reserve* court latched.

Quite simply, the Court cited to the *Avrahami* case to decide issues against Reserve that were neither relevant to Reserve’s facts nor were contested in the *Reserve* litigation. In *Avrahami*, the captive (Feedback) participated in a pooling arrangement through Pan American in its attempt to achieve risk distribution for the captive. The tax court in *Avrahami* concluded that it is necessary for it to decide whether Pan American was a “bona fide insurance company” before the court

could decide whether Feedback distributed risk through the Pan American pooling arrangement.<sup>171</sup> *No previous case had ever even suggested that a pooling arrangement was required to be a “bona fide insurance company” for the pooling arrangement to effectively distribute risk to participant reinsurers under the pooling arrangement.*<sup>172</sup> Nor had the government ever taken this position. *Reserve* set out “whether PoolRe was a bona fide insurance company” as a threshold issue in furtherance of its being shoehorned into *Avrahami*.

The issue relevant to risk distribution that was before the Court in *Reserve* was whether Reserve had a sufficient level of risk distribution when considering its PoolRe participation. This was answered in the affirmative by a Ph.D.-credentialed insurance economist and Wharton professor of insurance economics of national reputation, who was recognized as an expert by the Court on this and five previous occasions and who had studied PoolRe’s pooling arrangement in depth.<sup>173</sup> Reserve presented substantial evidence to prove that its participation in the PoolRe pooling arrangement enabled it to effectively distribute risk among PoolRe’s many other captive participants, which (by way of example in 2010) involved 200+ different unrelated insureds and 600+ policies being pooled (shared) and reinsured by the participating captives. The government did not provide any evidence at trial to controvert Dr. Doherty’s expert testimony that Reserve’s participation in the PoolRe pooling arrangement was effective in achieving a widespread risk distribution on behalf of Reserve. Instead, the government simply argued that Reserve bore the burden of proof to show that its reinsurance agreement with PoolRe distributed risk and that Reserve failed to meet its burden of proof.<sup>174</sup> In fact, Reserve met its burden of proof on the issue of risk distribution by introducing credible evidence in the form of Dr. Doherty’s expert testimony, which was not controverted by the government.

Whether PoolRe was a bona fide insurance company was not an issue before the *Reserve* Court; it was not contested at trial. Nor is it a requirement for a risk pool to achieve risk distribution. In *Reserve*, the government did not present evidence contesting whether PoolRe qualified as a bona fide insurance company. The issue of PoolRe being an insurance company was never briefed by either party in the simultaneous post-trial opening briefs. This issue was only briefed for the first time in the simultaneous answering briefs that were filed by both parties after the issuance of the *Avrahami* opinion.<sup>175</sup> Despite there being no contest as to PoolRe being a bona fide insurance company at trial, after *Avrahami* was decided (***being more than three months after the conclusion of the trial in Reserve***), the Court decided *sua sponte* to make this an issue after the fact, requesting that the parties file a post-trial “issues memorandum” to explain the relevancy of the holding in *Avrahami* to the facts and issues present in *Reserve*.<sup>176</sup> Jurisdictionally, a party’s failure to raise an issue at trial or in its opening brief prevents the party from being able to subsequently raise a new issue in its reply brief that was not previously addressed.<sup>177</sup>

The government devoted 14 pages of its answering brief and 5 pages of its *Avrahami* “issues memorandum” to addressing the 9 factors of the “bona fide insurance company” test (applied by the *Avrahami* court to the Pan American pooling arrangement) in its attempt to shoehorn Reserve’s arrangement with PoolRe into this same analysis. However, in these filings with the Court, the government failed to cite to evidence to support its arguments with respect to each factor. Nonetheless, Reserve met its burden of proof at trial through its participation in the PoolRe pooling arrangement and further demonstrated at trial that PoolRe was a bona fide insurance company.<sup>178</sup>

In analyzing insurance for federal income tax purposes, the Court in *Reserve* did not base its analysis on recognized legal concepts that courts have set out over the last three-quarters of a century. The Court made numerous findings that were not supported by the evidence on uncontested issues for which the government did not offer any evidence. Instead, the Court (encouraged by the government) imposed self-crafted requirements (not even suggested by the parties), which were not contested issues in the *Reserve* trial (e.g., whether PoolRe is a bona fide insurance company).

Commentary No. 4 addresses further issues with respect to the Court's erroneous application of *Avrahami* as authority for its many findings and the "shoehorn approach" that was employed by the Court in its attempt to fit *Reserve*'s facts into the legal standards of *Avrahami*.

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<sup>1</sup> See testimony of Norman Zumbaum, Tr. at 112-113.

<sup>2</sup> See Tr. at 114-116.

<sup>3</sup> See Tr. at 115.

<sup>4</sup> See testimony of Norman Zumbaum, Tr. at 109-110.

<sup>5</sup> See testimony of Norman Zumbaum, Tr. at 118-119.

<sup>6</sup> See testimony of Norman Zumbaum, Tr. at 110-111.

<sup>7</sup> See testimony of Norman Zumbaum, Tr. at 111, 119-120.

<sup>8</sup> See testimony of Norman Zumbaum, Tr. at 118-119.

<sup>9</sup> See testimony of Norman Zumbaum, Tr. at 107-108.

<sup>10</sup> The CERCLA Superfund legislation is codified as amended at 42 U.S.C. §§ 9601-9675 (2000).

<sup>11</sup> See testimony of Norman Zumbaum, Tr. at 112.

<sup>12</sup> See testimony of Norman Zumbaum, Tr. at 96, 103-104.

<sup>13</sup> Unless otherwise specified, all statutory section references are to the Internal Revenue Code of 1986, as amended, and all regulatory references are to the Treasury regulations as in effect and applicable to the year or years at issue.

<sup>14</sup> See testimony of Norman Zumbaum, Tr. at 133-138 and testimony of Norman Zumbaum on cross-examination at 154-156.

<sup>15</sup> See testimony of Norman Zumbaum, Tr. at 135-138, 165-167. On cross-examination, Mr. Zumbaum testified that he "scanned through them" when asked by the government's counsel if he looked at any of

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the insurance policies for the entities that were insured by Reserve. He further testified that the “folks from Capstone” were “our advisors” and that it was therefore “fair to say that whenever [the] folks from Capstone told him about [the coverages provided under the terms of Reserve’s insurance policies],” he believed and relied upon what was communicated to him.

<sup>16</sup> Opinion at 50.

<sup>17</sup> See testimony of Norman Zumbaum, Tr. at 107-108.

<sup>18</sup> See Exhibit 27-J (Reserve Casualty Corp., Audited Financial Statements and Notes, Statutory Basis, December 31, 2010 and the Period from inception to December 31, 2009 and Independent Auditor’s Report of Liptz & Associates, Inc.), page 6, Note 2(c). Note 2(c) states: “[Reserve] participates in a reinsurance risk pooling program with other unrelated insurance companies (“pool participants”), of which there were 58 in 2010. This risk pool is operated by an unaffiliated regulated insurance corporation, PoolRe Insurance Corp. (“PoolRe”). Each pool participant has one or more affiliated operating entities for which it underwrites insurance coverage, which is generally similar casualty-type coverages. PoolRe participates in these policies through Stop Loss insurance contracts. In total, the PoolRe sponsored risk pool comprises more than 650 Stop Loss insurance contracts for more than 200 insureds, which includes policies issue by [Reserve] as well as those issued by the other pool participants, all of which are unrelated insurance companies.”

<sup>19</sup> See testimony of actuary Gary Fagg, Tr. at 437-447, Exhibit 114-P (Expert Report of Gary Fagg, March 27, 2017), Exhibit 52-J (Credit Insurance Coinsurance Contract Issued to PoolRe by Reserve, 2008 policy), Exhibit 72-J (Credit Insurance Coinsurance Contract Issued to PoolRe by Reserve, 2009 policy), and Exhibit 52-J (Credit Insurance Coinsurance Contract Issued to PoolRe by Reserve, 2010 policy). Mr. Fagg’s uncontroverted testimony was that Reserve agreed to assume a portion of the liability in exchange for premiums from an unrelated company, CreditRe Reassurance Corp., through PoolRe as an intermediary, with respect to contractual liability coverages that originated with Lyndon Insurance. Mr. Fagg testified that he was closely involved with negotiating and administering this entire reinsurance arrangement for each year at issue.

<sup>20</sup> See testimony of Steve Kinion, Tr. at 224.

<sup>21</sup> See testimony of Dr. Neil Doherty, Tr. at 267-269, 280-282.

<sup>22</sup> See testimony of Dr. Neil Doherty, Tr. at 267-269, 280-282.

<sup>23</sup> See testimony of Esperanza Mead, Tr. at 407-436, and Exhibit 113-P (Expert Actuarial Peer Review Report of Esperanza Mead dated March 10, 2017). See also testimony of Michael Solomon, Tr. at 466-494, and Exhibit 117-P (Expert Actuarial Review Report of Michael Solomon dated March 27, 2017).

<sup>24</sup> See testimony of Dr. Neil Doherty, Tr. at 235-236 and Exhibit 104-P (Expert Report of Dr. Neil Doherty, dated March 27, 2017).

<sup>25</sup> See testimony of Lance McNeel, Tr. at 323-361.

<sup>26</sup> See testimony of Steve Kinion, Tr. at 197-226 and Exhibit 103-P (Expert Report of Steve Kinion dated March 26, 2017).

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<sup>27</sup> See testimony of David Liptz, Tr. at 520-595 and Exhibit 130-P (Expert Report of David B. Liptz, CPA dated March 23, 2017).

<sup>28</sup> See testimony of Bob Snyder, Tr. at 18-85 and Exhibit 97-P (Expert Report of Bob Snyder, dated March 27, 2017).

<sup>29</sup> See testimony of Gary Fagg, Tr. at 437-447 and Exhibit 114-P (Expert Report of Gary Fagg dated March 27, 2017).

<sup>30</sup> See Exhibit 95-J (Letter from actuary Steven Glicksman to Capstone's Lance McNeel, CPCU dated January 31, 2012 with "Discussion of PoolRe's Coverage Options"), which also referenced a previous letter from Mr. Glicksman dated October 20, 2009.

<sup>31</sup> See testimony of Donald J. Riggin, Tr. at 925 and Exhibit 136-R (Opening Expert Report of Donald J. Riggin, dated March 27, 2017). Mr. Riggin had no opinion regarding the pricing of even a single policy and did not make any determination that the premiums charged by Reserve or PoolRe were either overstated or understated.

<sup>32</sup> See testimony of Bob Snyder, Tr. at 81-85 and Exhibit 97-P (Expert Report of Bob Snyder, dated March 27, 2017).

<sup>33</sup> See testimony of Dr. Neil Doherty, Tr. at 235-236 and Exhibit 104-P (Expert Report of Dr. Neil Doherty, dated March 27, 2017) at 17-18.

<sup>34</sup> See testimony of Esperanza Mead, Tr. at 407-436, and Exhibit 113-P (Expert Actuarial Peer Review Report of Esperanza Mead dated March 10, 2017). See also testimony of Michael Solomon, Tr. at 466-494, and Exhibit 117-P (Expert Actuarial Review Report of Michael Solomon dated March 27, 2017).

<sup>35</sup> See testimony of Steve Kinion, Tr. at 197-226 and Exhibit 103-P (Expert Report of Steve Kinion dated March 26, 2017). Mr. Kinion, who is the head of Delaware's Bureau of Captive and Financial Insurance Products, testified that Anguilla's regulatory structure for captive insurance companies was similar to Delaware's well recognized captive regulatory structure.

<sup>36</sup> *Id.*

<sup>37</sup> See testimony of David Liptz, CPA, at Tr. at 569-573.

<sup>38</sup> Opinion at 6, 16-20.

<sup>39</sup> See Exhibit 136-R (Opening Expert Report of Donald J. Riggin, dated March 27, 2017) at 7-10. Mr. Riggin's expert report alleged that there were only "two quantitative, mathematically based methodologies available to commercial lines underwriters to rate insurance risk: (1) the Commercial Lines Manual (CLM), and (2) actuarial forecasting." Mr. Riggin further alleged in his expert report that "The lack of any loss history severely hampers Capstone's ability to determine premiums, regardless of the amount of professional oversight." On cross-examination, Mr. Riggin reluctantly admitted that premiums could be determined without a history of loss data, consistent with an article that Mr. Riggin himself had published, which he failed to reference in his expert report in violation of T.C. Rule 143(g). See testimony of Donald J. Riggin, Tr. at 905-911. Mr. Riggin also admitted on cross-examination that he had not even reviewed the CLM in "about a year" and that he did not check the CLM to determine

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whether the types of policies issued by Reserve could even be rated using the CLM, which only addressed specific coverage. See testimony of Donald J. Riggin, Tr. at 889-891.

Further, in his rebuttal expert report to Mr. Riggin's expert report, Dr. Doherty refuted Mr. Riggin's claim that a loss history was necessary for Capstone to be able to determine premiums. Dr. Doherty stated that Reserve's policies insured "unusual and new risks" that "typically are not supported by a long and large loss history" and characterized Reserve's rate setting process as "one of expert opinion, which draws on extensive market experience of rates for a variety of risks, market conditions, prevailing rates for somewhat comparable risks (both within and outside the Capstone program), third party review, and, to the extent possible, historical data." Dr. Doherty further noted that "actuarial input is not too far removed from these expert opinion rates" and that "because such expert opinion rates draw closely on market rates for comparable risks, and these market rates usually draw on actuarial input, this is a form of bootstrapping on actuarial methods and data." See Exhibit 107-P (Rebuttal of Expert Report of Mr. Donald J. Riggin, dated April 5, 2017), at 6. Reserve set its premiums based upon both actuarial input and the experience of the professional underwriters as well as market pricing quotes. See testimony of Lance McNeel, Tr. at 323-361. See also testimony of Dr. Neil Doherty, Tr. at 295, where Dr. Doherty confirmed that actuarial data was used to compute Reserve's premiums.

<sup>40</sup> See Appendix E of Exhibit 136-R (Opening Expert Report of Donald J. Riggin, dated March 27, 2017). See also Opinion at 61 where the Court found that the premiums for Reserve's policies were calculated "using objective criteria and what appear to be actuarial methods." The only 3 policies underwritten by Reserve that Mr. Riggin alleged to not cover certain legitimate insurable risks were the following policies: (1) Special Risk - Loss of Services Insurance Policy, (2) Special Risk - Tax Liability Policy, and, (3) Excess Directors & Officers Policy.

<sup>41</sup> See testimony of Donald J. Riggin, Tr. at 853, 862-863 and Exhibit 136-R (Opening Expert Report of Donald Riggin, dated March 27, 2017). See also <https://www.verisk.com/insurance/products/commercial-lines-manual-clm-information-on-isonet/> and <https://www.verisk.com/about/#>.

<sup>42</sup> See testimony of Donald J. Riggin, Tr. at 891.

<sup>43</sup> See 61 of the Opinion.

<sup>44</sup> In the Opinion at 46, the Court found that "PoolRe's activities as they relate to [Reserve's quota share policies with PoolRe] were not those of a bona fide insurance company" even though PoolRe was not a party and this was not an issue presented to the Court.

<sup>45</sup> For example, the Court made findings regarding whether the non-party Peak insureds had a need or business purpose for acquiring insurance from Reserve. In the Opinion at 60, the Court stated as follows: "The facts **do not reflect that [non-party] Peak had a genuine need for acquiring additional insurance** during the tax years in issue. There was no significant history of losses that would justify such a drastic increase, and Zumbaum's testimony that he was concerned about increased risks beginning in 2008 did not support a significant increase in insurance coverage. **All the direct written policies included a provision that the coverage afforded by the policy would be valid only after insurance coverage from other insurers was exhausted. Peak had never come close to exhausting the policy limits of its third-party commercial insurance coverage.**" (Emphasis added).

The Court erroneously read the policies' contractual terms. There was no other coverage for the Peak insureds' risks obtained through Reserve. The policies in question included an industry-standard general



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provision that provided if there were other coverage (which there wasn't), that Reserve's policies would be secondary. The Court erroneously took this to mean that the insureds would have to exhaust the limits on all commercial policies regardless of what they covered before Reserve's policies would apply. As a matter of law, the tax court was fundamentally in error in its interpretation of the policy and was clearly erroneous in so finding based on the evidence presented at trial.

<sup>46</sup> See 47 of the Opinion, where the Court concluded that the coinsurance contracts that Reserve executed with PoolRe were not bona fide reinsurance agreements, stating: "On the basis of the relevant facts and circumstances we conclude that the coinsurance contracts were not bona fide reinsurance agreements. Reserve has not established that the contracts underlying the purported reinsurance transactions existed or that the transactions involved actual risk." The Opinion did not cite to any authority to support this erroneous statement regarding an uncontroverted fact that was established at trial.

<sup>47</sup> The existence of the coinsurance contracts and terms of the reinsurance arrangement were established by uncontroverted expert witness testimony and documentary evidence. See Exhibit 104-P (Expert Report of Dr. Neil Doherty, dated March 27, 2017), at page 15, where Dr. Doherty described the reinsurance arrangement with respect to the coinsurance contracts as follows: "In the second part of the Capstone program, the captives of the various members assume more unrelated insurance under a second reinsurance program between PoolRe, and a unrelated reinsurer, Credit Re... Credit Re reinsures a form of contractual liability risk associated with vehicle service contracts and writes many thousands of policies. The risk exposure on these policies is unrelated to the Capstone participating companies. The overall pool of exposures assumed by PoolRe is then reinsured on a proportional (quota share) basis with more than 50 captive insurers."

Under the terms of the coinsurance contracts themselves, which were in evidence for each year at issue (See Exhibit 52-J for 2008, Exhibit 72-J for 2009, and Exhibit 87-J for 2010), Reserve agreed to assume a portion of the liability and premiums that was assumed from an unrelated company, CreditRe Reassurance Corp., with respect to contractual liability coverages that originated with Lyndon, a publicly-held insurer. The uncontroverted testimony of Gary Fagg, an actuary who was closely involved with negotiating and administering this entire reinsurance arrangement for the years at issue, established the existence of these coinsurance contracts and the specifics of the reinsurance arrangement for each year at issue. See testimony of Gary Fagg, Tr. at 442-447 and Exhibit 52-J (Credit Insurance Coinsurance Contract Issued to PoolRe Insurance Corp. by Reserve CC effective November 26, 2008). Despite the uncontroverted testimony, the Court stated otherwise in its Opinion without analysis or citation.

<sup>48</sup> The government's opening statement characterized Reserve as a "tax shelter" from the outset. The government's opening statement began as follows: "Your Honor, this is about Petitioner's owners, Norman Zumbaum and Corey Weikel, **moving money from one pocket to another for the sole purpose of reducing their taxable income.** The evidence will show that each time Petitioner engaged in one of the alleged insurance transactions at issue, there was **no purpose behind it but for the generation of tax-free income by manipulating Section 501(c)(15) to create a corresponding tax benefit for its owners.**" (Emphasis added). See Tr. at 13-14. However, failing to carry through its assertions in the opening statement, the government provided no evidence to support the argument that Reserve's insurance failed to serve a legitimate non-tax business purpose of either Reserve or its insureds.

<sup>49</sup> See *Moline Properties, Inc. v. Commissioner*, 319 U.S. 436 (1943), which established that a taxpayer's decision to create separate corporations to conduct its business will be respected for tax purposes so long as the separate corporations carry on real business activity.

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<sup>50</sup> Congress imposed no limitation on an insured's ownership under Section 501(c)(15). Contrary to the government's unsupportable argument as to Section 501(c)(15), Congress not only expected, but (practically speaking) mandated that the insureds and the insurer be related when operating under Section 831(b), which was amended by the Consolidated Appropriations Act of 2015, also known more commonly as the Protecting Americans From Tax Hikes Act (the "PATH" Act), effective for tax years beginning after December 31, 2016. The PATH Act added a new "diversification requirement" that must be satisfied by a captive operating under IRC §831(b). This "diversification requirement" can be met by a captive satisfying one of two alternative tests, with the second test for satisfying this diversification requirement essentially requiring mirror ownership of the insureds (within a 2% de minimis margin) with that of the insurer. Congress added this provision to prevent a captive's ownership structure from being used as an estate planning vehicle to have the effect of transferring wealth from the company's owners to their descendants without paying estate taxes. The addition of this diversification requirement in the PATH Act evidences that Congress expected the insureds and the insurer to be related when operating under IRC §831(b).

<sup>51</sup> The Court's limited analysis in *Reserve* focused on what it thought the law *should be* – putting itself into a legislative role – despite the taxpayers' compliance with the substance and form of what has been set out by Congress in legislation and what over decades has been interpreted by the courts. Appellate courts have recently made clear to this same Court that its role is not to block Congress' legislation facilitating a taxpayer qualifying for tax benefits by satisfying the precise requirements of the Internal Revenue Code. See *Summa Holdings Inc. v. Commissioner*, 848 F.3d 779 (6th Cir. 2017), where the Sixth Circuit reversed the tax court and held that the taxpayers in *Summa* were entitled to use a congressionally created corporation to transfer money from their family-owned company to their sons' Roth Individual Retirement Accounts (IRAs). See also the related cases of *Benenson v. Commissioner*, 887 F.3d 511 (1st Cir. 2018) and *Benenson v. Commissioner*, No. 16-2953 (2d Cir. 2018), recently decided by the Second Circuit on December 14, 2018. Both *Summa* and the two *Benenson* cases are discussed further beginning at page 8.

<sup>52</sup> See Exhibit 28-P (Reserve 2008 General Ledger), Account 50100 (Loss Expenses), reflecting \$56,399.81 losses paid in 2008 in connection with "other reinsurance."

See also Exhibit 29-P (Reserve 2009 General Ledger), Account 50100 (Loss Expenses), reflecting \$70,332.19 losses paid in 2009 in connection with "other reinsurance."

See also Exhibit 30-P (Reserve 2010 General Ledger), Account 50100 (Loss Expenses), reflecting \$56,399.81 losses paid in 2010 in connection with "other reinsurance."

<sup>53</sup> Unpublished decisions generally are: (i) available on the Tax Court's website from 1995 to-date and (ii) address cases that do not involve novel legal issues for which the law is settled or for which the result is factually driven. Although these opinions are technically not precedential, they are often cited by litigants, and the Tax Court does not regard these opinions lightly. Approximately 90% of opinions are tax court memo opinions. See also <https://www.taxcontroversy360.com/2016/10/types-of-tax-court-opinions-and-their-precedential-effect/>.

<sup>54</sup> See testimony of Norman Zumbaum, Tr. at 123-124 where Mr. Zumbaum testified that Peak was unable to get pollution insurance due to Peak being located in a "Superfund site" and further testifying that he didn't know "of any insurance companies in Idaho that would provide any insurance coverage to companies like Peak. See also Exhibit 16-J (Captive Insurance Feasibility Study for Peak Mechanical & Components, Inc., Initial Site Visit: August 13, 2008), 19-21, Section IV.1 (Business Operations

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Information Summary), subsection on “Other Risk Management Issues,” identifying 13 different risks that Peak faced that “are not now adequately covered by conventional insurance” and describing why each risk identified was a significant risk to Peak’s business operations. These risks identified in the feasibility study formed the heart of the risks that were later insured by Reserve pursuant to Peak’s insurance program.

<sup>55</sup> See Exhibit 1-J (Notice of Deficiency Issued to Reserve on March 29, 2016 by Department of Treasury, Internal Revenue Service). The government’s notice of deficiency simply asserted that Reserve was not a tax-exempt insurance company within the meaning of IRC section 501(c)(15) for the tax years in issue. The government based this assertion on the following determinations: (1) Reserve’s purported insurance transactions and/or reinsurance transactions “lack[ed] economic substance” and (2) in the alternative, Reserve was not an insurance company within the meaning of subchapter L of the Internal Revenue Code, since “its primary and predominant activity [was] not insurance.” The government argued the “economic substance” doctrine, stating that “the purported premium payments made by Peak to petitioner for the alleged captive insurance coverages had no economic substance beyond tax benefits and further stated that “Peak, RocQuest, and ZW Enterprises have failed to demonstrate a nontax business purpose for entering into the captive insurance arrangement for the purported insurance and/or reinsurance transactions at issue in this case.” See Simultaneous Opening Brief for Respondent (filed August 7, 2017) at 51.

<sup>56</sup> See Opinion at 60.

<sup>57</sup> See Opinion at 62.

<sup>58</sup> See *Commissioner of Internal Revenue v. Treganowan*, 183 F.2d 288, 290-291 (2d Cir. 1950), where the court stated as follows: “From an insurance standpoint there is no risk unless there is uncertainty or, to use a better term, fortuitousness. It may be uncertain whether the risk will materialize in any particular case. Even death may be considered fortuitous, because the time of its occurrence is beyond control.” See also *R.V.I. Guaranty Co. v. Commissioner*, 145 T.C. 209, 222 (2015), where the Tax Court held that contracts issued by R.V.I. Guaranty Co. (RVI) that insured against the risk that the actual value of an asset upon termination of a lease would be significantly lower than the expected value are contracts of “insurance” since losses under RVI’s policies are caused by fortuitous events outside of its control.” (Emphasis added).

<sup>59</sup> 848 F.3d 779 (6th Cir. 2017).

<sup>60</sup> See *Summa* at 782.

<sup>61</sup> 887 F.3d 511 (1st Cir. 2018).

<sup>62</sup> See *Benenson* at 518.

<sup>63</sup> See *Benenson* at 523.

<sup>64</sup> See IRC Section 501(c)(15)(A)(i)(I) and IRC Section 501(c)(15)(A)(i)(II).

<sup>65</sup> See IRC Section 331(a). Amounts received by a shareholder in a distribution in complete liquidation of a corporation are treated as in full payment in exchange for the stock of such corporation.

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<sup>66</sup> See *Securitas Holdings, Inc. & Subsidiaries v. Commissioner of Internal Revenue*, T.C. Memo 2014-225; *Rent-A-Center, Inc. & Affiliated Subsidiaries v. Commissioner of Internal Revenue*, 142 T.C. 1 (2014); *United Parcel Service of America, Inc. v. Commissioner*, TC Memo 1999-268, 78 TCM 262, rev'd 254 F.3d 1014 (11th Cir. 2001); *Hospital Corporation of America v. Commissioner*, T.C. Memo 1997-482 (1997); *Kidde Industries, Inc. v. United States*, 40 Fed. Cl. 42 (1997); *Ocean Drilling & Exploration Co. v. U.S.*, 24 Cl. Ct. 714, 92-1 (Fed. Cl. 1991), aff'd per cur. 988 F.2d 1135 (Fed. Cir. 1993); *Harper Group v. Commissioner*, 96 T.C. 45 at 60 (1991), aff'd, 979 F.2d 1341 (9th Cir. 1992); *AMERCO v. Commissioner*, 96 T.C. 18 at 42 (1991), aff'd 979 F.2d 162 (9th Cir. 1992); *Humana, Inc. v. Commissioner*, 881 F.2d 247 (6th Cir. 1989); and *R.V.I. Guaranty Co. v. Commissioner*, 145 TC No. 9 (Sept. 21, 2015).

<sup>67</sup> 149 T.C. No. 7 (August 21, 2017).

<sup>68</sup> See also testimony of Dr. Neil Doherty, Tr. at 235-236 and Exhibit 104-P (Expert Report of Dr. Neil Doherty, dated March 27, 2017), at 14-15, where Dr. Doherty explained this industry standard concept of “layering risk” as follows: “Under the [Reserve insurance] program, the [insured affiliate] insures part of its insurable exposures with its captive and part with an outside insurer, PoolRe. This breakdown between the captive and PoolRe is interesting and reflects a common insurance practice of layering risk. Each member of the Capstone program insures losses up to some threshold with its own captive. Or, in other words, the first layer of each member’s losses is insured with its own captive. Each member then insures losses above the threshold (the higher layer) with PoolRe. Thus, PoolRe insures the larger losses (or larger accumulations of claims) incurred by each member, leaving the smaller (and unaccumulated) losses with the captive.”

<sup>69</sup> See testimony of Lance McNeel, Tr. at 355-357, discussing Capstone’s underwriter’s pricing procedures and factors considered with respect to evolving insurance policy pricing policies for year-to-year.

<sup>70</sup> See testimony of Lance McNeel, Tr. at 323-361.

<sup>71</sup> See Opinion at 14, where the Court states as follows: “According to the evidence, all participants in the quota share arrangement agreed to direct their affiliated insureds to pay the same percentage of direct written premiums to PoolRe. As in *Avrahami v. Commissioner*, 149 T.C. at \_ (slip op. at 69), we are concerned with a one-size-fits-all rate for all the participants in the quota share arrangement.”

<sup>72</sup> The Court misquotes this policy’s language at 14, omitting the subsequent key paragraph of the policy. See, for example, Exhibit 75-J (Excess Directors & Officers Liability Insurance Policy), at 2.

<sup>73</sup> See, e.g., Exhibit 75-J (Excess Directors & Officers Liability Insurance Policy), at 2. The Court omitted this portion of the policy in its discussion at 14 of the Opinion.

<sup>74</sup> See Opinion at 14.

<sup>75</sup> See Opinion at 61.

<sup>76</sup> See testimony of Donald J. Riggin, Tr. at 925 and Exhibit 136-R (Opening Expert Report of Donald J. Riggin, dated March 27, 2017). Mr. Riggin, as the government’s sole expert witness, had no opinion regarding the pricing of even a single policy and did not make any determination in his expert report that the premiums charged by Reserve or PoolRe were either overstated or understated.

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<sup>77</sup> See note 15, *supra*.

<sup>78</sup> See testimony of Lance McNeel, CPCU, Tr. at 396-366, testifying on the underwriting and pricing procedures implemented for Reserve. See also testimony of CPA David Liptz, Tr. at 521-609, testifying on the audit procedures employed by Liptz & Associates with respect to the preparation of audited financial statements for Reserve. See also Exhibit 109-P (Pricing Indications, for policy periods ending December 31, 2008-2010, prepared for Reserve by Mid-Continent General Agency, Inc., Underwriters at Lloyds of London).

<sup>79</sup> See testimony of Norman Zumbaum, Tr. at 135-138 and testimony of Norman Zumbaum on cross-examination at 165-167. Mr. Zumbaum testified that the “folks from Capstone” were “our advisors” and that he relied upon what was communicated to him by them.

<sup>80</sup> In the Opinion at 51, the Court stated as follows: “There is no evidence that Reserve performed any due diligence with respect to the reinsurance agreements that it executed with PoolRe. With respect to the quota share arrangement it agreed to assume risks relating to a number of different businesses and a number of different lines of insurance. Nothing in the record indicates that Reserve or anyone performing activities on Reserve’s behalf evaluated these risks before executing the quota share policies.” These statements by the Court were simply not true but neither are they relevant to the issues at hand. The details of the expected pooling arrangement and reinsurance arrangement with PoolRe were explained in detail in the feasibility study that was issued to Peak Mechanical. Furthermore, the fact that Reserve executed the quota share agreement with PoolRe is evidence that its owners read and understood the PoolRe pooling arrangement. See *Hayes v. Travelers Ins. Co.*, 93 F.2d 568, 571 (10th Cir. 1937) (holding that, one having the capacity and opportunity to read a contract, who executes it without reading it, in the absence of fraud or imposition, or special circumstances excusing his failure to read it, is charged with knowledge of its contents and cannot avoid the contract by asserting that it did not express what he intended). It is especially odd when non-parties to a contract argue against its full force and effect while the parties to the contract take no issue with such. If this argument had been made by the government – which it was not – as opposed to its being raised *sua sponte* by the Court, the government, as a non-party to the contract, wouldn’t even have standing to complain.

In the Opinion at 51-52, the Court further stated that “Reserve contends that the reinsurance agreements allowed it to distribute risk. However, Reserve did not show that anyone with a financial interest in its operations considered the details of the quota share policies and the coinsurance contracts and considered whether risk was distributed. Zumbaum did not understand the details of Reserve’s operations and relied upon Capstone’s advice. There is no evidence that Reserve engaged in any due diligence to determine whether it was adequately distributing risk.”

As explained above, Capstone and other advisors counseled Reserve on the pooling arrangement and other reinsurance activities which PoolRe ceded to Reserve, and Reserve’s owners were well aware of (and do not dispute) these activities before Reserve executed the quota share policies and participated in the pooling arrangement making hundreds of thousands of dollars of payments to it. The above comments from the Court do not respect the fact that a captive insurance arrangement is a complex undertaking and that it is usual and typical for the persons responsible for administering the captive to rely on its advisors, including qualified insurance professionals, attorneys, accountants, actuaries, etc. The Court is apparently establishing a new standard in contract law wherein an agreement is only binding on a party if a third party (the government) can conclude that the signatory’s officers and owner sufficiently considered (in the Court’s view) the implications of entering into the agreement. The Court’s analysis is an anathema to contract law.

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<sup>81</sup> See Exhibit 16-J (Captive Insurance Feasibility Study for Peak Mechanical & Components, Inc., Initial Site Visit: August 13, 2008), at 22, Section IV.2 (Advantages to Captives), subsection on “Goals with Respect to Forming a Captive.”

<sup>82</sup> See testimony of Lance McNeel, Tr. at 403-404, where Mr. McNeel testified that “the feasibility study was drafted a few weeks after the site visit,” which took place in August 2008 and well ahead of Reserve’s formation on December 3, 2008.

<sup>83</sup> Willis is a global multinational risk management, insurance brokerage, reinsurance brokerage, and advisory company. It is the world's third-largest insurance broker with 39,000 employees.

<sup>84</sup> See Opinion at 11.

<sup>85</sup> See testimony of Lance McNeel, Tr. at 403-404, where Mr. McNeel testified that “the feasibility study was drafted a few weeks after the site visit,” which took place in August 2008.

<sup>86</sup> See Opinion at 11, where the Court stated: “In August 2009 the finalized feasibility study for Peak was issued, about nine months after the start of Reserve’s operations. The background documents compiled to support the feasibility study included documents that reflected Peak’s financial information through August 31, 2009, and the background file was updated as late as December 14, 2009.”

<sup>87</sup> *Id.*

<sup>88</sup> In the Opinion at 12, the Court stated that “The [feasibility] study did not provide detailed information regarding the other risks that [commercial] insurance might not cover. The study provided brief descriptions of these risks, but it included no information on the probability that these risks might occur.” The Court is establishing some new, heretofore unarticulated industry standard for feasibility studies that does not exist. The objective of the feasibility study was clearly set forth in the document itself as follows: “This feasibility study evaluates Peak’s desire to explore the option of forming a captive insurer for the purpose of writing coverages that are generally unavailable or impractical to obtain in the conventional insurance marketplace.” See Exhibit 16-J (Captive Insurance Feasibility Study for Peak Mechanical & Components, Inc., Initial Site Visit: August 13, 2008), page 1. The purpose of the feasibility study was not to actuarially price risks, as the Court would have it, for coverages given that the coverages had not yet been decided upon as of the completion of the feasibility study’s fieldwork on August 13, 2008.

Simply put, the Court is making an incorrect argument, establishing *sua sponte* its desired content in a feasibility study, which never before had been suggested, and then concluding that these elevated and newly articulated requirements hadn’t been met.

<sup>89</sup> See Exhibit 142-P (Article Published by Donald J. Riggin in February 2016 entitled “Captive Feasibility Studies – Necessary?”), in which Mr. Riggin even states: “The only constant is that the majority of captive domiciles require some sort of documentation that suggests that the applicant has thought about this and has a reasonably good reason to form a captive.” Mr. Riggin then described in this article what he viewed to be the “three types of captive feasibility studies: comprehensive, close-to-comprehensive (financial-only), and self-serving (nonfeasibility).” Mr. Riggin acknowledged in the article that a feasibility study is not required to form a captive.

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<sup>90</sup> For example, see Opinion at 59, where the Court expressed its view without citation as to precedent that a necessary requirement for a feasibility study is to provide information on “the probability of a loss event.” The Court continued: “The feasibility study provided no information on the probability of a loss event that the direct written policies covered. It also did not explain in detail how the direct written policies (which as noted above had not been decided upon as of the date of the feasibility study) would supplement Peak’s existing insurance.” But see Exhibit 16-J (Captive Insurance Feasibility Study for Peak Mechanical & Components, Inc., Initial Site Visit: August 13, 2008), pages 19-21, which proposes a range of 13 additional, relevant coverages for the Peak insureds. The Court provided no support for its newly manufactured standards for a feasibility study requiring loss projections, which has never been held to be a tax requirement for forming an insurer. The government’s own expert never even suggested such.

<sup>91</sup> See Exhibit 16-J (Captive Insurance Feasibility Study for Peak Mechanical & Components, Inc., Initial Site Visit: August 13, 2008), pages 24-34.

<sup>92</sup> In the Opinion at 12-13, the Court stated that “Robert Snyder signed the study as senior vice president of Willis. [Lance] McNeel was principal author of the study, and Snyder’s role was to review it. Snyder did not perform any independent investigation of Peak’s business operations, and he based his review on the background documents that Capstone compiled and an oral briefing from McNeel.” Snyder found McNeel trustworthy and had worked with him for many years. Snyder testified at trial that “Lance McNeel and I happened to be colleagues, not in the same division but we worked together for a number of years at Johnson & Higgins, the original firm where I started my career, and so we knew each other in passing and through company functions and so forth.” See testimony of Robert Snyder, Tr. at 27. When asked to describe his role in the feasibility study and the work that he performed in conjunction with Mr. McNeel following Mr. McNeel’s onsite visit to Peak’s Idaho facilities to “do the first line work on [Peak’s] feasibility study,” Mr. Snyder testified as follows: “[Mr. McNeel and I] would have discussed at a point in time all of the assembled material that was gathered. He would have given me a briefing, an oral briefing on what the company’s business was about, who the owners were, what the scope of the operations were, general discussion about the business, and I would have had an opportunity to ask him questions to get a finer understanding.” See testimony of Robert Snyder, Tr. at 58-59. **Mr. Snyder further testified that, in signing off on Peak’s feasibility study on behalf of Willis, he was verifying that “[i]t would have been jointly our view that I was affirming that formation of a captive insurance company made business and financial sense for this particular client.”** (Emphasis added). See testimony of Robert Snyder, Tr. at 62. Based on Mr. Snyder’s uncontroverted testimony above, the Court had no basis for slighting the work that he performed in preparing and signing off on Peak’s feasibility study, which he still stood by almost ten years later.

<sup>93</sup> See testimony of Bob Snyder, Tr. at 25-26.

<sup>94</sup> See Opinion at 12-13, where the Court wrongfully implied that Mr. Snyder’s role in the feasibility study was limited to a high-level review, which was not consistent with the testimony provided by Mr. Snyder at trial. See note 92 supra, summarizing Mr. Snyder’s testimony, whereby he described in detail his specific role and his work performed prior to signing off on Peak’s feasibility study.

<sup>95</sup> See Exhibit 16-J (Captive Insurance Feasibility Study for Peak Mechanical & Components, Inc., Initial Site Visit: August 13, 2008). At both 3 and 52, the feasibility study contains the signature of Robert L. Snyder, signing on behalf of Willis as “Senior Vice President.”

<sup>96</sup> See testimony of Bob Snyder, Tr. at 25-28.

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<sup>97</sup> The process followed in issuing the feasibility study was similar to a Court having its clerks prepare legal memorandum or drafts of opinions for review and further analysis by the Court. The final product bore the names of both Willis and Capstone, reflecting the contributions of each party to the final version of the feasibility study, with each of Willis and Capstone agreeing on the final report.

<sup>98</sup> For example, see article on [Captive.com](#) by P. Bruce Wright, M. Kristan Rizzolo, and Saren Goldner Oliver, “Group Captives, Cell Captives, and Risk Pooling Arrangements Guide,” February 1, 2017. The article can be found [here](#) and describes captive pooling arrangements as follows:

“Pooling arrangements are sometimes employed as a way to reduce loss variability and achieve the risk shifting and risk distribution necessary for premiums paid to a captive insurance company to be deductible for the insured parent. Although risk pooling arrangements may differ in structure, the effect is to take risks of multiple captive insurance companies and share them among the participating captives. Thus, for example, each of 10 captive insurance companies owned by 10 unrelated insureds (each of which insures only the risk of its owner) can cede all (or a portion of) its assumed risk to a single unrelated entity, X, and then assume a portion of X's business so assumed. For ease of illustration, assume each captive cedes the same amount of premium. In this scenario, each captive would typically participate as a reinsurer in 10 percent of the pooled risk and would assume as a cedent 10 percent of each cedent's risk (including their own). So, in the end, each captive would have 90 percent of the other parties' risk. In some cases, pools are entirely operated by a third party who decides who can participate and who cannot. In other cases, a third party administers the pool, but the pool members make decisions as to terms, who can participate, ... In some cases, pools are entirely operated by a third party who decides who can participate and who cannot. In other cases, a third party administers the pool, but the pool members make decisions as to terms, who can participate, ...”

<sup>99</sup> See testimony of Lance McNeel, Tr. at 368-372 and Exhibit 95-J (Report of actuary Steven Glicksman to Capstone's Lance McNeel, CPCU dated January 31, 2012 with “Discussion of PoolRe's Coverage Options”), which also referenced his prior October 20, 2009 report.

<sup>100</sup> See Exhibit 16-J (Captive Insurance Feasibility Study for Peak Mechanical & Components, Inc., Initial Site Visit: August 13, 2008), at 22, Section IV.2 (Advantages to Captives), subsection on “Goals With Respect to Forming a Captive.” The feasibility study clearly explained the purpose of the PoolRe pooling arrangement to be administered by Capstone as follows: “The captive's risk diversification efforts will be handled predominantly through coverage design, through participation in an insurance pooling of similar policies among unrelated companies and through the reinsurance assumption of unrelated business, most of which is expected to be co-arranged and co administered by Capstone. In addition, the proposed insured expects Capstone to help ensure improved service over conventional insurers, increase control of its risk management program, and to enhance its overall risk management perspective.”

<sup>101</sup> As discussed in note 68 *supra*, Dr. Doherty testified at trial that the PoolRe pooling arrangement reflected “a common insurance practice of layering risk,” explaining this concept in his expert report as follows: “Each member of the Capstone program insures losses up to some threshold with its own captive. Or, in other words, the first layer of each member's losses are insured with its own captive. Each member then insures losses above the threshold (the higher layer) with PoolRe. Thus, PoolRe insures the larger losses (or larger accumulations of claims) incurred by each member, leaving the smaller (and unaccumulated) losses with the captive.” See testimony of Dr. Neil Doherty, Tr. at 235-236 and Exhibit 104-P (Expert Report of Dr. Neil Doherty, dated March 27, 2017), at 14-15.

<sup>102</sup> See testimony of Lance McNeel, Tr. at 323-361.



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<sup>103</sup> See testimony of Lance McNeel, Tr. at 356. McNeel testified that that Capstone's pricing procedures were unique to each captive insurance company that Capstone managed, taking into account multiple individual risk factors. See also note 136 *infra*.

<sup>104</sup> See Exhibit 27-J (Reserve Casualty Corp., Audited Financial Statements and Notes, Statutory Basis, **December 31, 2010** and the Period from inception to December 31, 2009), page 6, Note 2(c) entitled "Reinsurance Pool Program," which states as follows: "The Company participates in a reinsurance pooling program with other unrelated insurance companies ("pool participants"), **of which there were 58 in 2010**. This risk pool is operated by an unaffiliated regulated insurance corporation, PoolRe Insurance Corp. ("PoolRe"). Each pool participant has one or more affiliated operating entities for which it underwrites insurance coverage, which is generally similar casualty-type coverages. PoolRe participates in these policies through Stop Loss insurance contracts. In total, the PoolRe sponsored risk pool comprises **more than 650 Stop Loss insurance contracts for more than 200 insureds**, which include policies issued by the Company as well as those issued by the other pool participants, all of which are unrelated insurance companies." (Emphasis added).

See also Exhibit 125-P (Reserve Casualty Corp., Audited Financial Statements and Notes, Statutory Basis, from inception to **December 31, 2009**), page 6, Note 2(c) entitled "Reinsurance Pool Program," which states as follows: "The Company participates in a reinsurance risk pooling program with other unrelated insurance companies ("pool participants"), **of which there were more than fifty in 2009**. This risk pool is operated by an unaffiliated regulated insurance corporation, PoolRe Insurance Corp. ("PoolRe"). Each pool participant has one or more affiliated operating entities for which it underwrites insurance coverage, which is generally similar casualty-type coverages. PoolRe participates in these policies through Stop Loss insurance contracts. In total, the PoolRe sponsored risk pool comprises **more than 500 Stop Loss insurance contracts for more than 150 insureds**, which includes policies issued by the Company as well as those issued by the other pool participants, all of which are unrelated insurance companies." (Emphasis added).

See also Exhibit 105-R (Expert Witness Report Request from The Feldman Law Firm to Dr. Neil A. Doherty, dated June 6, 2013), page 4, Table A: Summary of Risk Pool for 2008. "**In 2008**, PoolRe issued stop loss endorsements on **429 stop loss insurance policies to 155 named insureds** and reinsured (retroceded) for a premium paid to each of **44 participating reinsurers**, which novated the risks from PoolRe to the retroceded insurers." (Emphasis added).

<sup>105</sup> *Id.*

<sup>106</sup> See testimony of Bob Snyder, Tr. at 51-52. See also testimony of Lance McNeel, Tr. at 382. Both of these witnesses testified that PoolRe was a licensed insurance company (domiciled in the British Virgin Islands and later domiciled in Anguilla) during all years in issue. The government never even controverted this position, yet the Court erroneously implied that, for 2008, there was no evidence of PoolRe's licensing. See Opinion at 44-45.

<sup>107</sup> *Id.* See Opinion at 44-45.

<sup>108</sup> See Opinion at 45-46. The Court stated at 45: "We conclude that the facts surrounding Reserve's quota share policies with PoolRe establish that those agreements were not bona fide insurance agreements."

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<sup>109</sup> See Opinion at 38: “Before we can determine whether Reserve effectively distributed risk through these agreements, we must determine whether PoolRe was a bona fide insurance company. See Avrahami v. Commissioner, 149 T.C. at \_ (slip op. at 66-67).”

<sup>110</sup> Additionally, in September 2005, the IRS had issued a ruling to PoolRe (shortly after its April 2005 name change from “CNC Property & Casualty Insurance Corporation,”) concluding that PoolRe satisfied the requisites as an insurer for purposes of Section 501(c)(15) under the Internal Revenue Code. In that ruling the IRS stated as follows:

*“We are pleased to inform you that upon review of your application for tax exempt status we have determined that you are exempt from Federal income. tax under section 501(c)(15) of the Internal Revenue Code. Because this letter could help resolve any questions regarding your exempt status, you should keep it in your permanent records.*

*You are. exempt for all tax years beginning before January 1, 2004, when your net written premiums (or, if greater, direct written premiums) do not exceed \$350,000.*

*For tax years beginning on or after January 1, 2004, you are exempt if (a) your gross receipts for the taxable. year do not exceed \$600,000, and (b) more. than 50 percent of your gross receipts for the taxable year consists of premiums. See section 501(c)(15)(A)(i) of the Code. For purposes of these tests, amounts received by entities affiliated with you are taken into account if the entities are members of your controlled group. See section 501(c)(15)(C).”*

<sup>111</sup> The scope of the testimony of Donald Riggin, the government’s sole expert witness, was limited to the following issues as set forth in his **opening expert report**: (1) whether he considered the “so-called” premiums paid by the insured parties to Reserve to be actual premiums as would be calculated by a conventional *multiline insurer*, which he answered in the negative, (2) whether the role of portfolio diversity was effective in distributing risk from an insurance industry perspective, which he answered in the negative, and (3) whether the Reserve arrangement, as structured and executed, was in accordance with insurance industry standards and practices in its dealings with its three named insured companies at issue (i.e., Peak Mechanical & Components, Inc., RocQuest, LLC, and ZW Enterprises, LLC), which he answered in the negative. See Exhibit 136-R (Opening Expert Report of Donald J. Riggin, dated March 27, 2017). In his **rebuttal expert report**, the scope of Mr. Riggin’s testimony was limited to a rebuttal of Reserve’s experts on the following issues: (a) Dr. Neil Doherty’s opinion that Reserve’s insurance structure distributes insurance risk, (b) CPCU Robert L. Snyder’s opinion that the Reserve coverages served to augment commercially obtained insurance, (c) Actuary Gary Fagg’s opinion that the CreditRe loss exposures impacted Reserve’s core coverage risk distribution in the commonly accepted sense, (d) Actuary Esperanza Mead’s opinion on Reserve’s ability to estimate expected losses, in the absence of actual loss information, and (e) Actuary Michael Solomon’s opinion on premium pricing methodology with respect to coverages that did not use actual loss data. See Exhibit 137-R (Rebuttal Expert Report of Donald J. Riggin, April 10, 2017).

<sup>112</sup> See testimony of Norman Zumbaum, Tr. at 123, where Mr. Zumbaum stated that “I think in the valley we probably couldn’t get pollution insurance” due to Peak being located in a “Superfund site.” See also Tr. at 119-120, where Mr. Zumbaum stated that, because of pollutants, being in a floodplain, “that’s kind of what spurred the Superfund site through the years of history is the mining companies dumping their tailings back in the day and floods and disbursed it through the valley.” Mr. Zumbaum further testified that “it’s a very narrow valley” that is “probably two miles wide, three at the most ... so it’s really concentrated in that valley. It’s not like it’s a 50-mile wide valley or something.”

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<sup>113</sup> In the Opinion at 57, the Court summarily concluded in determining the lack of need for pollution liability coverage: “Peak itself did not engage in mining practices that spread pollutants, and it already had systems in place to control the fluid runoff when it cleaned equipment used in polluted mines.”

<sup>114</sup> The position of the sole expert witness for the government, Donald Riggin, in his expert report at 9-10, ¶ 26, was that, absent either a history of losses or access to the Commercial Lines Manual, it was not possible to price premiums. However, in cross examination, Riggin admitted there were instances in which premiums could be developed without prior loss history. In fact, Mr. Riggin’s own undisclosed publications espoused views directly contrary to that of his own report and testimony, leading to the Court expressing concern about the testimony of the government’s sole substantive witness. See Riggin testimony, Tr. at 862-863, 904-905, 910 and Exhibit 136-R (Opening Expert Report of Donald J. Riggin, March 27, 2017).

<sup>115</sup> See *Gonzalez v. C.I.R.*, T.C. Memo. 1977-240 (1977) (holding that the tax court, as the fact-finder, has the responsibility of using [its] best judgment as the fact-finder in reaching the conclusion which accords most satisfactorily with the record as a whole, taking into account the demeanor and credibility of the witnesses, including the petitioner). See also *Phipps v. C.I.R.*, 127 F.2d 214, 217 (1942) (holding that a fact-finding body such as the Board of Tax Appeals [or U.S. Tax Court] may disregard the opinion of an expert and use its own judgment in arriving at value, **but it may not reject opinion evidence and make an arbitrary finding of value unsupported by any substantial evidence**). (Emphasis added). See also *American Nat. Bank of Sapulpa, Okl. v. Bartlett*, 40 F.2d 21, 23 (10th Cir. 1930) (holding that the disposition of case becomes **question of law for the trial court, where evidence is undisputed** such that a relevant fact is not in substantial dispute and the real question is the conclusion to be drawn therefrom by the trial court). (Emphasis added). See also *Nelson v. Montgomery Ward & Co.*, 312 U.S. 373, 376 (1941) (holding that the effect of admitted [and uncontroverted] facts is a question of law).

<sup>116</sup> See Exhibit 136-R (Opening Expert Report of Donald J. Riggin, March 27, 2017).

<sup>117</sup> See Opinion at 61.

<sup>118</sup> See testimony of Donald J. Riggin, Tr. at 925 and Exhibit 136-R (Opening Expert Report of Donald J. Riggin, March 27, 2017). Mr. Riggin, as the government’s sole expert witness, had no opinion regarding the specific pricing of even a single policy among the thousands at issue in trial and declined to make any determination in his expert report that the premiums charged by Reserve or PoolRe were either overstated or understated or reasonable in amount.

<sup>119</sup> See testimony of Esperanza Mead, Tr. at 407-436, and Exhibit 113-P (Expert Actuarial Peer Review Report of Esperanza Mead, March 10, 2017), at 7. Ms. Mead opined that Reserve’s “total premiums are reasonable” with respect to the following policies for each year (2008, 2009, and 2010) at issue: Cyber Risk Package Insurance Policy, Directors and Officers Insurance Policy, Employment Practices Liability Insurance Policy, Intellectual Property Package Insurance Policy, Legal Expense Reimbursement Insurance Policy, Special Risk - Expense Reimbursement Insurance Policy, Special Risk - Loss of Services Insurance Policy, and Special Risk - Regulatory Changes Insurance Policy.

See also testimony of Michael Solomon, Tr. at 466-494, and Exhibit 117-P (Expert Actuarial Review Report of Michael Solomon, March 27, 2017), at 15. Mr. Solomon opined on the reasonableness of the premiums paid to Reserve by its insureds with respect to the following policies issued by Reserve between 2008 and 2010: Pollution Liability, Special Risk - Tax Liability, Special Risk – Weather Related

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Business Interruption, Special Risk – Product Recall, Special Risk – Loss of Major Customer, and Special Risk – Punitive Wrap. Mr. Solomon stated as follows in his expert report at 15: “Because the premium paid by the Insureds is within the range of reasonable premium estimates, I consider the policy premiums reasonable in the aggregate. Additionally, because the premium paid by the Insureds is within the range of reasonable premium estimates for each year, I consider the policy premiums reasonable for each year.”

Between actuaries Mead and Solomon, all of the premiums for the 14 direct written policies were found to be reasonable. McNeel and Mid-Continent also opined on the pricing of Reserve’s direct written premiums. Actuary Glicksman opined on the pricing of the stop loss and quota share premiums. Actuary Fagg opined on the premiums received from a publicly held insurer (Lyndon), which were ceded to Reserve and flowed from third parties (and were therefore presumed to be at arm’s-length).

<sup>120</sup> See Opinion at 62: “We conclude that [all of] Reserve’s transactions were not insurance transactions in the commonly accepted sense.”

<sup>121</sup> See Opinion at 14, where the Court selected the following language (quoted previously at page 11) from Reserve’s direct written policies, erroneously concluding with the massaged excerpt that Peak’s coverages with third-party insurers were duplicative with the policies that Reserve issued to Peak and the other insureds, which was not the case:

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

Unexplainedly omitted by the Court in its excerpt was the following which runs totally contrary to the Court’s “analysis”: “THIS EXCESS POLICY DOES NOT REQUIRE THE INSURED TO MAINTAIN ANY SPECIFIC UNDERLYING PRIMARY INSURANCE POLICIES UNLESS SPECIFIED BY ENDORSEMENT TO THIS POLICY. **THE COVERAGES AFFORDED HEREIN WILL DROP DOWN AND PROVIDE COVERAGE ONLY IF THERE ARE NO OTHER VALID AND COLLECTIBLE INSURANCE POLICIES IN FORCE TO WHICH A CLAIM WOULD APPLY, SUBJECT TO THIS POLICY’S TERMS AND CONDITIONS.** (emphasis added.)

See also Opinion at 43, where the Court again erroneously implied that Peak’s coverages with third-party insurers were duplicative with Reserve’s policies, by stating as follows: “Under the terms of the direct written policies Reserve was liable for claims not covered by ‘any other valid and collectible insurance policy issued by any other insurer.’ Peak maintained extensive commercial insurance coverage with third-party insurers.” The Court erroneously interpreted this contractual provision to mean that “any other valid and collectible insurance policy” was not restricted to those that actually covered a particular loss. That is, the Court presumed that a workers’ compensation policy from a commercial carrier would cover a business interruption or pollution liability policy from Reserve, thus providing duplicate coverage. It was clearly wrong for the Court to conclude such from the contractual language.

<sup>122</sup> See Opinion at 60: “All the direct written policies included a provision that the coverage afforded by the policy would be valid only after insurance coverage from other insurers was exhausted. Peak had never come close to exhausting the policy limits of its third-party commercial insurance coverage.”

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<sup>123</sup> See Opinion at 60: “The facts do not reflect that Peak had a **genuine need** for acquiring additional insurance during the tax years in issue. There was no significant history of losses that would justify such a drastic increase, and Zumbaum’s testimony that he was concerned about increased risks beginning in 2008 did not support a significant increase in insurance coverage.” (Emphasis added). Yet see Opinion at 61: “Although Capstone calculated Reserve’s premiums using objective criteria and what appear to be actuarial methods, the **absence of a real business purpose** for Reserve’s policies leads us to conclude that the premiums paid for the policies were not reasonable and not negotiated at arm’s length.” (Emphasis added). In another reversal, see Opinion at 62: “However, [Reserve] was not operated as a bona fide insurance company, and there was **no legitimate business purpose** for the policies that Reserve issued for the insureds.” (Emphasis added).

<sup>124</sup> A reinsurance arrangement can informally be described as insurance purchased by an insurance company. A more technical definition of “reinsurance” is a transaction in which one party, the “reinsurer,” in consideration of a premium paid to it, agrees to indemnify another party, the “reinsured,” for part or all of the liability assumed by the reinsured under a policy of insurance that it has issued. The reinsured may also be referred to as the “original” or “primary” insurer or the “ceding company.” Captives commonly enter into reinsurance arrangements for a variety of reasons, including the following: (1) capacity management, (2) premium surplus relief, (3) stabilization of results, (4) catastrophe protection, (5) business withdrawal, and (6) underwriting expertise. See article on Captive.com, “How Do Captive Insurers Use Reinsurance?” published in 2015 by International Risk Management Institute, Inc. The article can be found [here](#).

<sup>125</sup> See Opinion at 46-47: “Reserve contends that liability for the pool of vehicle service contracts generated losses that offset premiums received during the tax years in issue. It failed to provide evidence that the vehicle service contracts, which formed the basis for the reinsurance that PoolRe re-ceded in the coinsurance contracts, actually existed. Fagg described a series of ceding transactions (i.e., from Lyndon to ARIA, from ARIA to CreditRe, and from CreditRe to PoolRe). Even if we agree with Reserve about the validity of the coinsurance contracts, any actual risk that PoolRe had in connection with the vehicle service contracts was de minimis, because PoolRe assumed liability for a small, blended portion of the overall pool of vehicle service contracts, and it re-ceded most or all of that liability to the Capstone entities. The amount ceded to Reserve was also de minimis. On the basis of the relevant facts and circumstances we conclude that the coinsurance contracts were not bona fide reinsurance agreements. Reserve has not established that the contracts underlying the purported reinsurance transactions existed or that the transactions involved actual risk.” **The Court’s above statements demonstrate that the Court failed to consider the nature of Reserve’s reinsurance arrangements and did not recognize the fact that Reserve’s reinsurance arrangements are treaty, not facultative, reinsurance arrangements.** Both types of reinsurance are described below. The Court incorrectly faulted Reserve for not having conducted itself in accordance with facultative reinsurance arrangements. The fact that Reserve as a relatively small insurer “only” assumed \$66,000 (in 2010, for example, which was almost 14% of Reserve’s overall 2008 revenues) in premiums related to the third-party insurance generated by Lyndon cannot result in a legal conclusion that its “de minimis” nature somehow negated that it was in fact insurance.

Reinsurance agreements generally take one of two basic forms, either “treaty” or “facultative” agreements. Under “**treaty reinsurance**,” there is a standing reinsurance agreement whereby, in exchange for an agreed premium, the treaty covers a class of insurance risks specified in the contract. Typically, the “cession” of the reinsured business by the cedent and the assumption of that business by the reinsurer are obligatory pursuant to treaty terms. That is, under treaty reinsurance premium, losses

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associated with the covered risks are automatically covered by the agreement to be transferred to the reinsurers. The reinsurer does not analyze the reinsured business on a policy-by-policy basis before accepting the risk cession. Treaty reinsurance was in place in the case of the Reserve-PoolRe-CreditRe-Aria-Lyndon arrangement.

In contrast with treaty reinsurance, “**facultative reinsurance**” does not result in an automatic cession of risk by the cedent, nor an automatic acceptance of risk by a reinsurer. Instead, facultative reinsurance permits an insurer to decide which specific insured risks will be submitted to a reinsurer for consideration. Upon such submission, the reinsurer has the opportunity to underwrite the individual risk and may elect to accept or decline such risk. See Fed. Ins. Office (“FIO”), U.S. Dep’t of Treas., The Breadth and Scope of the Global Reinsurance Market and the Critical Role Such Market Plays in Supporting Insurance in the United States, p. 7 (Dec. 2014), available at <https://www.treasury.gov/initiatives/fio/reports-and-notice/Docs/FIO%20-Reinsurance%20Report.pdf>. This U.S. Treasury Department publication, at pages 8 and 10, describes the differences between treaty reinsurance and facultative reinsurance.

The Court called the risk assumed by PoolRe and Reserve in connection with the vehicle service contracts “de minimis.” In fact, contrary to the Court’s “analysis,” Reserve accepted premiums (\$69,500 in 2008, \$76,500 in 2009, and \$66,000 in 2010) that were material to its revenues in each such year (which ranged from \$481,792 to \$1,006,216 over these three years). The pool was composed of many thousands of diversified, unaffiliated insurance contracts of which Reserve was one of many similar reinsurers. The Court’s criticism of Reserve’s participation in this large blended pool of insurance coverages evidences its failure to understand the function of an insurance pool and the concept of risk diversification.

<sup>126</sup> See testimony of Lance McNeel, Tr. at 341-342, and Exhibit 109-P (Pricing Indications, for policy periods ending December 31, 2008-2010, prepared for Reserve Casualty Corporation by Mid-Continent General Agency, Inc., Underwriters at Lloyds of London).

<sup>127</sup> See Opinion at 61: “With respect to premiums, the facts and circumstances of this case demonstrate that the direct written policies were not the result of arm’s-length negotiations. Taking into consideration all the surrounding facts and circumstances, we conclude that no unrelated party would reasonably agree to pay Reserve the premiums that Peak and the other insureds did for the coverage provided by the direct written policies. Although Capstone *calculated Reserve’s premiums using objective criteria and what appear to be actuarial methods*, the absence of a real business purpose for Reserve’s policies leads us to conclude that the premiums paid for the policies were not reasonable and not negotiated at arm’s length.” (Emphasis added). The Court did not cite to any authority or to the record for these statements. Negotiating premiums at arm’s-length has never been a requirement of an insurance arrangement, especially so where the Court acknowledged that the premiums were appropriately priced despite there being an affiliated relationship between Reserve and its insureds.

<sup>128</sup> See Opinion at 61.

<sup>129</sup> See note 48, *supra*. See also Cohen, *How to Read Tax Court Opinions*, 1 Hous. Bus. & Tax L. J. 1, 6 (2001). Cohen explains that tax court opinions are usually issued as memoranda decisions “if they involve application of familiar legal principles to routine factual situations, nonrecurring or enormously complicated factual situations from which guidance and precedent are too difficult to distill, obsolete statutes or regulations, straightforward factual determinations, or arguments patently lacking in merit.”

<sup>130</sup> See Opinion at 61: “Although Capstone calculated Reserve’s premiums using objective criteria and what appear to be actuarial methods, the absence of a real business purpose for Reserve’s policies leads us

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to conclude that the premiums paid for the policies were not reasonable and not negotiated at arm's length." At 62 of the Opinion, the Court concluded that "there was no legitimate business purpose for the policies that Reserve issued for the insureds."

<sup>131</sup> See testimony of Norman Zumbaum, at 109-110 and 118-119.

<sup>132</sup> See testimony of Stewart Feldman, Tr. at 708, 739.

<sup>133</sup> See Opinion at 60: "The facts do not reflect that Peak had a genuine need for acquiring additional insurance during the tax years in issue."

<sup>134</sup> See *Harper Group v. Commissioner*, 96 T.C. 45 (1991), *aff'd*, 979 F.2d 1341 (9th Cir. 1992). In *Harper*, the tax court specifically addressed the issue of setting premiums for a captive insurance company and its insured affiliates. The tax court noted that the premium rates charged "were determined by reference to competitive pricing gathered by the petitioner's management in the course of their business and incorporated in the rates approved by [the captive insurance company]." See *Harper*, 96 T.C. 45 (1991) at 50. The court specifically held that the determination of the premiums in this manner was proper. Notably, the court emphasized that "[s]uch rates were not determined by reference to actuarially determined loss projections." *Id.*

<sup>135</sup> See Exhibit 109-P (Mid-Continent General Agency, Inc. – Indication, Underwriters at Lloyds of London, Surplus Lines Company, Best Rating: A, XV for Reserve Casualty Corporation Policies Issued to Peak Mechanical & Components, Inc.). See also *Harper* at 50.

<sup>136</sup> See testimony of Lance McNeel, Tr. at 323-366 on the pricing procedures implemented for all pool participants, including Reserve. Mr. McNeel testified at 356 that Capstone's pricing procedures were unique to each captive insurance company that Capstone managed, taking into account multiple individual risk factors, summarized below. See also Exhibit 109-P (Mid-Continent General Agency, Inc. – Indication, Underwriters at Lloyds of London, Surplus Lines Company, Best Rating: A, XV for Reserve), Exhibit 110-P (Capstone Associated Services, Ltd – 2010 Policy Rate Analysis Summary), Exhibit 111-P (Increase Limit Factors), and Exhibit 112-P (Reserve Casualty Corp. – Rating Worksheet for Peak Mechanical, Inc. for policy years 2008-2010). Mr. McNeel testified that the premium pricing for each type of coverage that was underwritten by Reserve for coverages provided to the Peak insureds, as reflected on Exhibit 112-P, took into account multiple individual factors, including Reserve's premium indications (received from Mid-Continent), the applicable policy limit, the exposure basis (based on either the insured's revenue or the insured's number of employees), an increase limit factor, and the relevant policy period (i.e., whether the policy period was a short policy period or a full annual term policy period). Mr. McNeel testified that a "pro rata premium" was calculated using the rating worksheet for each coverage after considering all these factors. See Tr. at 356-366.

<sup>137</sup> See testimony of Esperanza Mead, Tr. at 407-436, and Exhibit 113-P (Expert Actuarial Peer Review Report of Esperanza Mead, March 10, 2017). See also testimony of Michael Solomon, at 466-494, and Exhibit 117-P (Expert Actuarial Review Report of Michael Solomon, March 27, 2017). Both of these actuaries testified that the pricing of Reserve's direct written policies was reasonable. See also Exhibit 95-J (Report from actuary Glicksman to Capstone's Lance McNeel, CPCU, January 31, 2012 with "Discussion of PoolRe's Coverage Options"), referencing a previous report from actuary Glicksman to McNeel, October 20, 2009. See pages 2-3 and "Exhibit -1" to Exhibit 95-J, discussing the factors considered by actuary Glicksman in calculating the percentage of direct written premiums to be paid to PoolRe by each participating captive.

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<sup>138</sup> See Opinion at 61.

<sup>139</sup> See Tr. at 925 and Exhibit 136-R (Opening Expert Report of Donald J. Riggin, March 27, 2017). Mr. Riggin had no opinion regarding the specific pricing of even a single policy and did not make any determination that the premiums charged by Reserve or PoolRe were either over- or understated or whether they were reasonable in amount.

<sup>140</sup> See Opinion at 61.

<sup>141</sup> See Opinion at 60.

<sup>142</sup> See Exhibit 30-P (Reserve 2010 General Ledger), Account 50100 (Loss Expenses), reflecting \$56,399.81 losses paid in 2010 in connection with “other reinsurance.”

<sup>143</sup> See Opinion at 11: “In August 2009 the finalized feasibility study for Peak was issued, about nine months after the start of Reserve’s operations. The background documents compiled to support the feasibility study included documents that reflected Peak’s financial information through August 31, 2009, and the background file was updated as late as December 14, 2009.” The signed feasibility study issued to Peak did not reference any 2009 financial information in support of its preparation. See Exhibit 16-J (Captive Insurance Feasibility Study for Peak Mechanical & Components, Inc., Initial Site Visit: August 13, 2008). The Court wrongfully implied otherwise.

<sup>144</sup> See testimony of Lance McNeel, Tr. at 403-404, where Mr. McNeel testified that “the feasibility study was drafted a few weeks after the August 2008 site visit”. See also testimony of Lance McNeel, Tr. at 313, 380-385.

<sup>145</sup> Opinion at 11.

<sup>146</sup> Opinion at 57: “Peak itself did not engage in mining practices that spread pollutants, and it already had systems in place to control the fluid runoff when it cleaned equipment used in polluted mines. In 2008 Peak had operated in Osburn continuously for over 10 years. Reserve provided no evidence that Peak had ever incurred costs during that time for excess pollution liability.” The Court brushed aside the fact that Peak’s operations were physically located in a Superfund site and that Peak’s captive feasibility study stated as follows: “A major risk exposure is pollution liability which is excluded from all underlying policies. In addition to the pollution risk of its own manufacturing and remanufacturing operations, there is an indeterminable pollution risk with its mining and other underground products should a product failure be the catalyst for a pollution incident at a customer's work site.” See Exhibit 16-J at 20.

A summary of each of the direct written policies underwritten by Reserve for each of 2008-10 is within Exhibit 35-J (Direct Written Policy Schedule for 2008), Exhibit 59-J (Direct Written Policy Schedule for 2009), and Exhibit 74-J (Direct Written Policy Schedule for 2010). Copies of each policy issued for 2008 can be found at Exhibit 36-J through Exhibit 48-J; for 2009 at Exhibit 60-J through Exhibit 70-J; and for 2010 at Exhibit 75-J through Exhibit 85-J, with revised exhibits for certain policies found at Exhibit 149-J through Exhibit 153-J. The significant risks not adequately covered by commercial insurance policies were identified in Peak’s feasibility study and are described in Exhibit 16-J (Captive Insurance Feasibility Study for Peak Mechanical & Components, Inc., Initial Site Visit: August 13, 2008), at 19-21, “Other Risk Management Issues.”



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<sup>147</sup> Pub. Law No. 96-510, 94 Stat. 2767 (1980) (codified as amended at 42 U.S.C. §§ 9601-9675 (2000)). CERCLA (sometimes referred to as the “Superfund” statute) refers to cleanup costs incurred in response to the release of hazardous substances as “response costs.” 42 U.S.C. § 9607(a)(4). A “potentially responsible party” or “PRP” under CERCLA is a person who fits within one of the four categories of “covered persons” set forth in CERCLA section 107(a)(1)-(4), 42 U.S.C. §9607(a)(1)-(4).

<sup>148</sup> See Petitioner’s Simultaneous Opening Brief (filed August 5, 2017), at 11-15, ¶¶ 38-51.

<sup>149</sup> Opinion at 57. The Court erroneously concluded that the Peak insureds, which conducted operations deep in contaminated mines, and were located on a Superfund site, did not face a material risk for pollution liability loss, stating as follows: “Reserve contends that Peak was on a Superfund site and could have been exposed to pollution liability, for which no third-party coverage was available. **Peak itself did not engage in mining practices that spread pollutants, and it already had systems in place to control the fluid runoff when it cleaned equipment used in polluted mines.**” (Emphasis added).

<sup>150</sup> See testimony of Donald J. Riggin, at 1001-1003.

<sup>151</sup> *Id.* at 1002.

<sup>152</sup> *Id.* at 1003.

<sup>153</sup> See testimony of Donald J. Riggin, Tr. at 928-929, where Mr. Riggin affirmed that he was testifying as an “insurance industry expert” in the *Reserve* case.

<sup>154</sup> See Petitioner’s Simultaneous Opening Brief (filed August 5, 2017), at 11-15, ¶¶ 38-51.

<sup>155</sup> See CERCLA section 107(a)(1), section 107(a)(2), section 107(a)(3), and section 107(a)(4). The four classes of parties that may be held liable as “potentially responsible parties” under CERCLA include the current owner or operator of the site, the owner or operator of a site at the time that disposal of a hazardous substance, pollutant or contaminant occurred; a person who arranged for the disposal of a hazardous substance, pollutant or contaminant at a site; and a person who transported a hazardous substance, pollutant or contaminant to a site, who also has selected that site for the disposal of the hazardous substances, pollutants or contaminants.

The pollution liability policy issued by Reserve expressly covered these CERCLA liability risks. See Exhibit 41-J (2008 Excess Pollution Liability Insurance Policy), Exhibit 65-J (2009 Excess Pollution Liability Insurance Policy), and Exhibit 150-J (2010 Excess Pollution Liability Insurance Policy). The below described provisions in each year’s policy reflect that liability risks were clearly encompassed by CERCLA.

For all 3 years at issue (2008-10), ¶ 1 of the pollution liability policy that Reserve issued to Peak stated as follows: “We agree to indemnify you for Clean-Up Costs on or under the Insured Property and to indemnify you for Diminution in Value of the Insured Property, if such Clean-Up Costs and Diminution in Value are sustained solely by reason of your discovery during the policy period of On-Site Pollution Conditions which commenced prior to the Retroactive Date.”

Paragraph 18(F) of the pollution liability policy defined “Clean-Up Costs” to include “costs and expenses of investigation or removal of, or rendering non-hazardous or less hazardous, Pollution Conditions to the

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extent required by Environmental Laws , or by governmental or court order or directive, or required or approved by a governmental agency, acting under authority granted by Environmental Laws.”

Paragraph 18(I) of the pollution liability policy defined “Environmental Laws” as “one or more of the following statutes, any amendments thereto, and any regulations promulgated thereunder, and any other applicable federal, state, and local laws pursuant to which you have or may have a legal obligation to incur Clean-Up Costs for On-Site or Off-Site Pollution Conditions or a Pollution Release, including but not limited to the: Comprehensive Environmental Response Compensation and Liability Act of 1980 (CERCLA), as amended by the Superfund Amendments and Reauthorization Act of 1986 (SARA), 42 U.S.C. 9601-9675.”

<sup>156</sup> Even if the Peak insureds had been before the Court, the appropriate test for determining whether a trade or business expense is deductible under Section 162 is whether that expense is “ordinary and necessary.” The term “necessary,” for purposes of §162, means that the expense is appropriate and helpful, rather than absolutely essential. See *Lilly v. Commissioner*, 343 U.S. 90 (1952), *red’s* 188 F.2d 269 (4th Cir. 1951), *aff’g* 14 T.C. 1066 (1950). The Tax Court has held that an expense could be necessary even though there are other ways of attaining the same result. See *United Title Ins. Co. v. Commissioner*, T.C. Memo 1988-38 at 46-47). The amounts incurred by Peak to purchase pollution insurance from Reserve clearly met the standards required for an expense to be deductible under Section 162.

<sup>157</sup> See testimony of Norman Zumbaum, Tr. at 123-124 where Mr. Zumbaum testified that “I think in the valley we probably couldn’t get pollution insurance” due to Peak being located in a “Superfund site.” Mr. Zumbaum testified that he didn’t know “of any insurance companies in Idaho that would provide any insurance coverage to companies like Peak in 2008, 2009, and 2010.” Further, the feasibility study that was issued to Peak contained the following statement on page 20 of the study: “A major risk exposure is pollution liability which is excluded from all underlying policies. In addition to the pollution risk of its own manufacturing and remanufacturing operations, there is an indeterminable pollution risk with its mining and other underground products should a product failure be the catalyst for a pollution incident at a customer’s work site.” (Emphasis added).

<sup>158</sup> The feasibility study for the Peak insureds, which was issued jointly by Capstone and Willis, was based on an on-site examination of Peak’s operations conducted in both Osborn and Hayden Lake, Idaho. The 52-page study described the risk management issues faced by Peak with respect to risks for which Peak did not have existing coverages. See Exhibit 16-J (Captive Insurance Feasibility Study for Peak Mechanical & Components, Inc., Initial Site Visit: August 13, 2008), at 19-21.

<sup>159</sup> See testimony of Norman Zumbaum, Tr. at 123-124 where Mr. Zumbaum testified that Peak was unable to get pollution insurance due to Peak being located in a “Superfund site” and that he didn’t know “of any insurance companies in Idaho that would provide any insurance coverage to companies like Peak. See also Tr. at 105-106, where Mr. Zumbaum testified that “mines in Silver alley are dangerous places to work.” Mr. Zumbaum also testified that “My partner Corey, in his younger years he was buried up to his neck in the mines at one time and thought he was going to lose his life. My dad, as a miner, he lost his partner that I know of, at least one, in a mining accident, and I’ve had numerous friends perish in the deep mines.”

<sup>160</sup> See Exhibit 97-P (Expert Report of Robert Snyder, March 27, 2017). Mr. Snyder concluded at page 2 that “The policies Reserve issued to Peak and the Affiliated Businesses during 2008, 2009 and 2010 covered insurable risks of Peak and the Affiliated Businesses because these were risks of Peak and the

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Affiliated Businesses that the insurance industry considers to be insurable risks.” At 7-11, Mr. Snyder analyzed each of Reserve’s direct written coverages and explained in detail precisely why each of Reserve’s 15 distinct policies was suitable to Peak’s unique risks in the mining industry. At 7, Mr. Snyder explained why each was appropriate to Peak’s unique risk management issues: “Peak was vulnerable to changes in the economics and regulations in the mining industry since 100% of its business is derived from mining. Unlike many of its competitors that have a more diversified customer base, Peak faced a severe risk exposure associated with loss of revenue resulting from changes in this single industry. Delineated below are the key risks that the Captive Insurance Company Feasibility Study- 2009 identified for potential to be insured through a captive insurer.” Finally, at 13-16, Mr. Snyder provided detailed illustrations of why each of 6 different policies were directly relevant to Peak’s risk management needs.

<sup>161</sup> See Exhibit 104-P (Expert Report of Dr. Neil Doherty, March 27, 2017). Dr. Doherty opined at 5 that “the policies of insurance purchased by Peak from Reserve and Pool Re, and the insurance arrangement involving Reserve, in 2008/9/10 provide ‘insurance’ as that term is understood by economists and by risk management theorists and professionals.” Dr. Doherty further opined at 18: “With respect to the types of coverages, insurance typically covers loss to the policyholder from fortuitous events. These include common perils such as weather and fire damage, liability claims, and more specialized risks such as loss of intellectual property, product recall and the like. The policies in place for the various Capstone members include a mixture of typical and specialized risk exposures. Policies of these types are routinely offered by the insurance industry.” (emphasis added)

<sup>162</sup> See Opinion at 47: “On the basis of the relevant facts and circumstances we conclude that the coinsurance contracts were not bona fide reinsurance agreements. Reserve has not established that the contracts underlying the purported reinsurance transactions existed or that the transactions involved actual risk.”

<sup>163</sup> See testimony of actuary Gary Fagg, Tr. at 437-447 and Exhibit 114-P (Expert Report of Gary Fagg, March 27, 2017). See also Exhibit 52-J (Credit Insurance Coinsurance Contract Issued to PoolRe by Reserve, 2008 policy), Exhibit 72-J (Credit Insurance Coinsurance Contract Issued to PoolRe by Reserve, 2009 policy), and Exhibit 52-J (Credit Insurance Coinsurance Contract Issued to PoolRe by Reserve, 2010 policy).

<sup>164</sup> See Opinion at 47, where the Court concluded that the coinsurance contracts that Reserve executed with PoolRe were not bona fide reinsurance agreements. See also note 47, *supra*, which explains that the existence of the coinsurance contracts and terms of the reinsurance arrangement were established by uncontroverted expert witness testimony and documentary evidence (providing citations to such evidence).

<sup>165</sup> See Opinion at 60: “The facts do not reflect that Peak had a genuine need for acquiring additional insurance during the tax years in issue. **There was no significant history of losses that would justify such a drastic increase**, and Zumbaum’s testimony that he was concerned about increased risks beginning in 2008 did not support a significant increase in insurance coverage.” (Emphasis added). Mr. Zumbaum’s testimony at trial, which focused on his concerns about Peak’s inability to obtain pollution coverage from a commercial insurer (due to Peak’s facilities being in a Superfund Site) clearly showed that his concerns about increased risks were justified. The Court chose not to address how there were losses (e.g., the \$339,820 in covered losses under a Reserve issued policy) paid, that this still didn’t satisfy the Court’s elevated standard.

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The fact is that Peak’s insurance expense increased because the comprehensiveness of its insurance coverages increased significantly, just as a business’ gasoline expenses might increase if it bought a larger truck. The Court already reluctantly acknowledged the reasonable pricing of the policies which were supported by four independent actuaries. This is uncontested. The Court conducted no analysis – which it could not – as to whether the policies acquired by the insureds were anything other than directly crafted for the risks of the Peak insureds.

<sup>166</sup> See *Commissioner of Internal Revenue v. Treganowan*, 183 F.2d 288, 290-291 (2d Cir. 1950), where the court stated as follows: “From an insurance standpoint there is no risk unless there is uncertainty or, to use a better term, fortuitousness. It may be uncertain whether the risk will materialize in any particular case. Even death may be considered fortuitous, because the time of its occurrence is beyond control.” See also *R.V.I. Guaranty Co.*, 145 TC No. 9, (Sept. 21, 2015), which the Court failed to distinguish and where the Court in *Reserve* also appears to have overruled its own decision. In *RVI Guaranty*, after citing to numerous state case law authorities, statutory financial statement rules and Congress’ intent to grant authority to states to regulate the business of insurance, the tax court concluded that contracts issued by RVI Guaranty to insure against the risk that the actual value of an asset upon termination of a lease would be significantly lower than the “expected value” are contracts of “insurance” caused by fortuitous events outside of RVI’s control. In doing so, the tax court gave a substantial amount of deference to the insurance domicile in governing RVI’s operations. In *Reserve*, multiple experts testified that each of Reserve’s policies covered insurable risks, and the government conceded that this was the case with respect to risks covered in at least 11 of the 14 policies. The Court went beyond the record in *Reserve*, concluding that none of Reserve’s policies were insurance and did not address the *RVI Guaranty* case or the “fortuitous risk” of loss concept that had been the focus of courts for decades.

<sup>167</sup> See also Rev. Rul. 89-96, referencing the Las Vegas MGM Grand fire in 1980. The ruling addresses a taxpayer that, because of a catastrophe, incurs a liability of unknown size that greatly exceeds the taxpayer’s current liability insurance coverage. After the catastrophe, the taxpayer enters into an arrangement with an insurer under which the insurer would pay the taxpayer’s liability up to a cap (which cap was less than the total liability the taxpayer expected to pay out, so the insurer expected to pay out the full cap amount). The taxpayer paid the insurer a premium for entering into the arrangement. The ruling states that the arrangement “does not involve the requisite risk shifting necessary for insurance. **The catastrophe has already occurred, and the economic terms of the contract demonstrate the absence of any transfer of risk apart from an investment risk ... Although the contract created certain risks for [the insurer], those risks are investment risks and not insurance risks.** Specifically, the only risks borne by [the insurer] in this situation are that it will be required to make payments with respect to a known loss earlier than expected and that the available investment yield between the time of payment of the premiums and the time of payment of the claims will be lower than expected.” (Emphasis added).

<sup>168</sup> Opinion at 47.

<sup>169</sup> Opinion at 62.

<sup>170</sup> The trial in *Reserve* concluded on May 2, 2017. Petitioner’s and Respondent’s opening briefs were filed simultaneously on or about August 5, 2017. ***Avrahami v. Commissioner was not decided by the Tax Court until August 21, 2017.***

<sup>171</sup> See *Avrahami* at 66-76.

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<sup>172</sup> In *Avrahami*, Judge Holmes erroneously cited to the *Rent-A-Center* case (which did not involve a pooling arrangement) for the proposition that the Pan American pooling arrangement (present in *Avrahami*) had to be a bona fide insurance company. This concept was nowhere addressed in *Rent-A-Center*.

<sup>173</sup> See Exhibit 104-P (Expert Report of Dr. Neil Doherty, March 27, 2017) at 19, concluding as to the efficacy of Reserve's participation in PoolRe in distributing risk: "Pool Re insures more than 150 largely unrelated business entities that are affiliates of the 50+ such captive insurance companies. This pooled insurance risk of Pool Re is then reinsured back to these captives on a proportional basis. The effect is that the captives, such as Reserve, insure the smaller losses of their affiliates, but pool the larger losses in such a manner that each captive typically ends up bearing less than 1/50th of these larger losses. Thus, the Capstone program enables Reserve (as well as its other member insurers) to spread their various owners' risks across a large pool of unrelated parties, thereby providing a wide distribution of risk. But the distribution goes even further. In addition to the pooling of the risks of all Capstone members, Pool Re also reinsures vehicle service contract risks of outside parties (i.e., unrelated to the Capstone member entities) and then cedes this risk back to Reserve and the other Captives in the Pool Re program. In this way, Reserve is able to provide an effective and widespread distribution of risk as is typical of other insurance programs."

<sup>174</sup> See Answering Brief for Respondent (October 13, 2017) at 36, 40-41. The government argued in its answering brief that the only evidence available regarding the pooling arrangement was the quota share agreement (which identified the participating captives by a number) and that "there was no evidence as to what other parties were involved as counterparties to the PoolRe reinsurance transactions, what their risks were, what amounts of exposure existed, and what industries, locations, or operations they had." Before the *Reserve* Opinion, no case had ever required an insurer to present evidence from each participant in a pooling arrangement regarding their industries, locations, operations, types of risks, and exposures to risk. Reserve met its burden of proof on the issue of risk distribution in the form of the expert testimony of Dr. Neil Doherty, a nationally recognized Ph.D.-credentialed insurance economist from The Wharton School, who explained PoolRe's pooling arrangement in detail and why the pooling arrangement was effective in achieving risk distribution on behalf of Reserve. See Exhibit 104-P (Expert Report of Dr. Neil Doherty, dated March 27, 2017), at 14-17, Part 2a (Risk Distribution).

<sup>175</sup> The first time that the issue of whether PoolRe was a bona fide insurance company was briefed by the parties was in the simultaneous answering briefs, which were filed on or about October 11, 2017.

<sup>176</sup> The Court issued an order on October 16, 2017 to provide both parties with an opportunity to submit an "issues memorandum" to address any issues related to the issuance of the *Avrahami* opinion. Both parties filed an *Avrahami* "issues memorandum" on or about October 31, 2017.

<sup>177</sup> A party generally cannot raise a new issue on brief, see, e.g., *Sundstrand Corp. v. Commissioner*, 96 T.C. 226, 346-48 (1991), especially if it would surprise and prejudice the other party. *Seligman v. Commissioner*, 84 T.C. 191, 198 (1985), *aff'd*, 796 F.2d 116 (5th Cir. 1986). A party must address all issues in its opening brief and may not reserve an argument for a reply brief such that the opposing party is disadvantaged by an inability to respond. *Hayden v. Commissioner*, 55 T.C.M. (CCH) 1290, 1294 (argument raised for first time in reply brief was not considered), *aff'd*, 889 F.2d 1548 (6th Cir. 1988). The answering or reply brief should set forth any objections to disputed proposed findings in the opponent's opening brief. Tax Ct. R. 151(e)(3). Otherwise, the Court may conclude that the answering party conceded the point. See e.g., *Jonson v. Commissioner*, 118 T.C. 106, 108 n.4 (2002), *aff'd*, 353 F.3d 1181 (10th Cir. 2003).

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<sup>178</sup> A subsequent commentary will evaluate each of the 6 factors of the “bona fide insurance company” test that were discussed by the Court in the *Reserve* Opinion and compare the Court’s findings with the evidence that was actually presented at trial.