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Commentary #4 by Capstone Associated Services, Ltd.

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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 continuing the series on the recent Opinion issued in *Reserve*, this fourth commentary addresses the issues involving the Court's erroneous application of the facts to the law and the misapplication of *Avrahami v. Commissioner*[1] (opinion filed August 21, 2017) as authority for its many findings in its Opinion in *Reserve*.

The *Reserve* Opinion and trial transcript can be found here, along with additional links to the opening briefs, reply briefs, and issues memoranda that were filed both by Petitioner (Reserve) and by Respondent (Internal Revenue Service) in *Reserve*.

Avrahami's August 21, 2017 opinion played no role in the *Reserve* trial because *Reserve's* trial ended more than three months earlier on May 2, 2017. Even the *Reserve* post-trial opening briefs were filed prior to the *Avrahami* opinion's release. *Avrahami* was first addressed by the parties in *Reserve* in their simultaneous reply briefs (filed on October 10, 2018) and by each party in an "issues memorandum" (simultaneously filed on October 31, 2017), which the Court requested to address the *Avrahami* decision in a short, ten-page brief.

The issues memorandum filed by Reserve to address *Avrahami* can be found here.

The issues memorandum filed by the government to address *Avrahami* can be found here.

Despite the significantly different facts and jurisdictional posture of *Reserve* relative to *Avrahami* (see below), the Court erred in remaking the facts of *Reserve* to fit into the legal findings of *Avrahami*, while demonstrating a lack of understanding of how insurance works in the business community. In doing so, the Court cast aside long-standing statutory provisions designed to encourage the formation of captive insurers by small and mid-size businesses.

Reserve filed a Motion for Reconsideration with the Tax Court on July 18, 2018 on a single issue, which can be found here.[2] On August 17, 2018, the Court summarily denied the motion. The order denying the motion can be found here.

Capstone's initial statement and previous commentaries on the Court's Opinion can be found here.

As background, prior to the issuance of *Avrahami* in August 2017, whether an arrangement is treated as an insurance arrangement for federal income tax purposes had never been distinguished by courts on the basis of whether the insurer was reporting under Sections 501(c)(15), 831(a) or 831(b) of the Internal Revenue Code.[3] *Avrahami* was the first court case to decide this issue for a company seeking tax treatment under Section 831(b), and *Reserve* was the first court case to decide this issue for a company seeking to be taxed under Section 501(c)(15). Previous case law addressing the taxation of captive insurance companies had decided this issue with respect to companies seeking tax treatment under Section 831(a).

I. The Court Erred in Finding that Reserve did not have a Legitimate Nontax Purpose

In *Reserve*, the Court failed to apply the proper legal standard of whether the formation of the captive had a legitimate nontax business purpose. Instead, it made several incorrect assumptions without supporting evidence to conclude otherwise. The Court ignored the testimony of Reserve's expert and fact witnesses as well as the documentary evidence admitted at trial.[4] No evidence was offered by the government to support the Court's finding that there was a lack of business purpose for Reserve's insurance arrangement.

The Court used this erroneous "lack of business purpose" conclusion as a basis for its numerous other incorrect findings. There were at least five different statements in the Opinion where the Court either: (a) stated without explanation that Reserve's captive insurance arrangement (and participation in the PoolRe pooling arrangement) did not have a legitimate nontax business purpose or (b) attempted to explain why it did not believe that the arrangement had a valid business purpose.[5] The Court's holdings were heavily influenced by its use of an incorrect standard for determining the existence of a business purpose of Reserve's insurance arrangement.

As a threshold matter, it appears that the Court did not understand the well-recognized business reasons for forming a captive insurance company, such as to fill-in gaps in coverage and enable the captive's insured operating business(es) to insure risks that are either too costly or otherwise unavailable in the commercial insurance marketplace.[6] The Court also did not discuss the well-established case law in the captive insurance area on the business purpose issue. Those authorities are discussed below.

United Parcel Service of America, Inc. v. Commissioner ("UPS"),[7] a case decided by the Eleventh Circuit Court of Appeals in 2001, is a leading case on what constitutes a valid business purpose for both a captive insurance arrangement and a reinsurance arrangement under which a third party agrees to reinsure some portion of the risks underwritten or assumed by a captive. UPS had historically made a lucrative profit from its "excess value charges" (i.e., shipping insurance premiums paid by UPS's customers to insure packages having a value in excess of $100) that were paid by customers for many years and had diligently tracked these shipments so that loss claims were relatively low. UPS decided to restructure its excess-value business, and in doing so, paid premiums equal to the excess value charges (net, after claims) to an independent insurer, National Fire Insurance Company ("National"). UPS continued to handle and process the claims on behalf of the insurer. National forwarded the net funds that it received, less a commission, to UPS's newly formed Bermuda captive, Overseas Partners

Limited ("OPL") in exchange for OPL agreeing to assume risk commensurate with the risk insured by National Union with respect to UPS's excess-value business. The Eleventh Circuit held that this captive insurance arrangement was valid, and that UPS could take a deduction for insurance premiums paid under the captive arrangement. The language below in *UPS* from the Eleventh Circuit is instructive:

> "There was a real insurance policy between UPS and National Union that gave National Union the right to receive the excess-value charges that UPS collected. And even if the odds of losing money on the policy were slim, National Union had assumed liability for the losses of UPS's excess-value shippers, again a genuine obligation. **A history of not losing money on a policy is no guarantee of such a future. Insurance companies indeed do not make a habit of issuing policies whose premiums do not exceed the claims anticipated, but that fact does not imply that insurance companies do not bear risk. Nor did the reinsurance treaty with OPL, while certainly reducing the odds of loss, completely foreclose the risk of loss because reinsurance treaties, like all agreements, are susceptible to default**."[8]
>
> "The transaction under challenge here simply altered the form of an existing, bona fide business, and this case therefore falls in with those that find an adequate business purpose to neutralize any tax-avoidance motive. True, UPS's restructuring was more sophisticated and complex than the usual tax-influenced form-of-business election or a choice of debt over equity financing. But its sophistication does not change the fact that **there was a real business that served the genuine need for customers to enjoy loss coverage and for UPS to lower its liability exposure**… We therefore conclude that UPS's restructuring of its excess-value business had both real economic effects and a business purpose, and it therefore under our precedent had sufficient economic substance to merit respect in taxation."[9]

Similar to UPS restructuring its excess-value business by forming a captive combined with a reinsurance arrangement (with National Union and OPL), both the formation of Reserve to insure Peak and Reserve entering into the pooling reinsurance arrangement with PoolRe served a legitimate business purpose. Each of Reserve's direct issued policies met the genuine needs that Peak had for each of the coverages identified in Peak's feasibility study. Further, as Dr. Doherty concluded in his expert report, PoolRe shifted a material portion of Reserve's risk of loss to the other participants in the pooling arrangement in exchange for Reserve assuming risks of unrelated captive participants, with the risks of all participating captives being blended for the collective benefit of all participants.[10] The fact that PoolRe did not have a history of paying claims for the three isolated years at issue (2008 – 2010) did not guarantee that PoolRe would not potentially have to pay future claims. Even if the odds of PoolRe paying a claim in a given year were slim, PoolRe assumed liability for a layer of Reserve's losses and each other participant's losses, which was a genuine obligation for which PoolRe bore a significant amount of risk. Section V(A)(6) of this commentary discusses in further detail the legitimate nontax business reasons for which PoolRe was created, as well as arguing that a showing of such a business purpose by PoolRe is not required under existing case law.

Humana, Inc. v. Commissioner[11] is another cornerstone captive insurance case that discusses a valid business purpose for forming a captive insurance company. In *Humana*, the Sixth Circuit upheld the deductibility of premiums paid to a captive insurance company, Health Care Indemnity, by its brother-sister corporations, which were subsidiaries of Humana, the parent company. The Sixth Circuit applied a narrower balance sheet approach instead of the IRS's promoted "economic family theory," which it specifically rejected. In discussing the issue of whether Humana had a valid business purpose for forming its captive, the Sixth Circuit noted that the Tax Court had found that that Humana had a valid business purpose for incorporating Health Care Indemnity, since Humana, a hospital chain with enormous risk exposure, found itself without coverage after its coverage was cancelled by its commercial carrier, Continental Insurance Co. (Continental). Continental had previously provided Humana with general liability insurance, including malpractice liability and workers' compensation insurance. Due to changing rules, economic inflation, and misjudgments, insurers were adjusting their loss reserves and premiums in the 1980s for many lines of casualty insurance, including malpractice insurance. The Sixth Circuit found that Humana faced an obvious dilemma and acted in a legitimate manner in seeking to find an answer by forming its captive to insure risks that were no longer covered by commercial insurance after it had attempted to obtain general and professional liability insurance from third-party insurers but was unsuccessful. The language from the Sixth Circuit in *Humana* regarding what constitutes a valid business purpose for forming a captive is useful:

> "In general, absent specific congressional intent to the contrary, as is the situation in this case, a court cannot disregard a transaction in the name of economic reality and substance over form **absent a finding of sham or lack of business purpose** under the relevant tax statute…. In the instant case, the tax court found that Humana had a valid business purpose for incorporating Health Care Indemnity. **Congress has manifested no intent to disregard the separate corporate entity in the context of captive insurers**. In short, the substance over form or economic reality argument under current legal application does not provide any justification for the tax court to reclassify the insurance premiums paid by the subsidiaries of Humana Inc. as nondeductible additions to a reserve for losses. The test to determine whether a transaction under [the Internal Revenue Code] is legitimate or illegitimate is not a vague and broad "economic reality" test. The test is whether there is risk shifting and risk distribution. Only if a transaction fails to meet the above two-pronged test can the court justifiably reclassify the transaction as something other than insurance."[12]

The evidence at trial established that the formation of Reserve served a legitimate nontax business purpose, which was similar to the business purpose found in both *UPS* and *Humana*. Similar to UPS forming OPL as a captive insurer to assume risks from National Union with respect to UPS's excess-value business, Reserve was formed to insure each of the risks that were specifically identified in Peak's feasibility study. Analogous to Humana forming Health Care Indemnity to insure coverage that had been cancelled by its commercial carrier for general liability insurance, each of the risks that were underwritten by Reserve were risks for which Peak was unable to obtain coverage from its existing commercial insurers. The formation of Reserve enabled Peak (and the other insureds) to insure risks that were either too costly or otherwise unavailable in the commercial insurance marketplace.

Another case that is instructive on how "business purpose" applies in the context of a captive insurance arrangement is *Malone & Hyde, Inc. v. Commissioner*.[13] *Malone & Hyde* involved facts similar to those in *Humana* in that Malone & Hyde created a captive subsidiary in Bermuda to provide insurance for it and its subsidiaries. It obtained a master policy from a domestic insurance provider which then entered into a reinsurance agreement with the captive. The Tax Court analyzed the facts in Malone & Hyde using the three-prong test for determining whether a transaction involved "insurance" for income tax purposes: (1) whether the transaction involves "insurance risks"; (2) whether there is risk shifting and risk distribution; and (3) whether there is "insurance" in its commonly accepted usage. The Tax Court applied the Humana net worth and balance sheet tests and looked at the impact that a claim of loss would have on the insured subsidiaries' assets. Under this criterion, the Tax Court held that the three-prong test was met and allowed the deduction.

On appeal, the Sixth Circuit in *Malone & Hyde* reversed, stating that the Tax Court put the cart before the horse in that it should have first determined whether the captive was a sham ***<u>before</u>*** it applied the three-prong test. The Sixth Circuit held that the insurance agreement in *Malone & Hyde* was a sham and distinguished it from *Humana* in that, unlike Humana, (1) Malone & Hyde had no problem obtaining insurance; (2) the captive in Malone & Hyde was undercapitalized; and (3) because of the undercapitalization, the reinsurance company required Malone & Hyde to sign a hold harmless agreement. By stating that a court should first determine if an insurance transaction is bona fide before it applies mechanical tests (i.e., the net worth or balance sheet tests) to determine whether risk shifting and risk distribution exist, the Sixth Circuit's decision in *Malone & Hyde* clarifies the *Humana* decision.

In *Reserve*, the Court confused the analysis and erred in failing to address the correct legal question as established by prior case law. Judge Kerrigan ignored the legal precedent that was established by the Sixth Circuit in *Malone & Hyde*. In doing so, the Court first purported to apply the "risk distribution" test to Reserve's insurance arrangement (by applying the "bona fide insurance company" test first introduced in *Avrahami* to PoolRe's pooling arrangement). The Court then followed the template that had been laid out by the Tax Court in *Avrahami* by purporting to apply the "insurance in the commonly accepted sense" test to Reserve's transactions. The Court only discussed Reserve's "business purpose" in the context of its attempt to apply the various factors for each of these two tests to Reserve's insurance arrangement. Thus, the Court conflated the business purpose issue with the separate issues of risk distribution and common notions of insurance. The Court did not follow the precedent set in *Malone & Hyde* by first determining whether the captive was a sham or whether it served a legitimate business purpose ***<u>before</u>*** it purported to apply the "risk distribution" and "insurance in the commonly accepted sense" tests to Reserve's transactions. As previously discussed, the Court simply assumed, without any supporting evidence, that there was not a legitimate business purpose for Reserve's captive insurance arrangement.

As discussed later in this commentary at Section V, the evidence at trial established that both of the tests enunciated by Judge Kerrigan in *Reserve* were satisfied. Even though these tests went well beyond what was required under established legal precedent, Reserve met its burden in establishing that: a) Reserve's participation in PoolRe satisfied the "bona fide insurance company" test and b) Reserve's transactions were "insurance in the commonly accepted sense."

II. The Court Erred in Using *Avrahami* as the Template for *Reserve*

The Court in *Reserve* noticeably used *Avrahami*[14] as the "template" for its Opinion despite the absence of factual similarities and *Avrahami*'s erroneous legal precedent.

The Court also ignored widespread insurance practices by imposing new and unsupportable requirements on the insurance industry, requiring that a pooling be done by an insurance company. In so doing, the Court relied on the *Avrahami* court's erroneous announcement of a new legal standard for a pooling arrangement, whereby the court incorrectly cited to *Rent-A-Center* for a concept not presented in that case. The Court was clearly erroneous in its analysis of the factual and expert witnesses. The *Reserve* Court went to great lengths to treat *Avrahami* as controlling, citing to *Avrahami* at least <u>12 different times</u> as the main support for its position despite the differing factual and legal postures between these two cases.

The result was that the Court appeared to mold *Reserve*'s facts and legal analysis into *Avrahami* without regard to (i) the issues presented and briefed, (ii) the evidence before it, (iii) the concessions by the government; and (iv) the differing jurisdictional posture of the cases. On the jurisdictional issue, in *Reserve*, only the captive – and neither the insureds nor the pooling arrangement nor the owners of the insureds – were before the Court. In contrast, in *Avrahami*, the insurer, the insureds and their owners were all before the court.

The little analysis seen in *Reserve* appeared to essentially mirror the three main sections of the *Avrahami* opinion without regard to the evidence presented by the twelve witnesses – two[15] from the government and ten from the petitioner, Reserve. Among these were 3 fact witnesses and 7 expert witnesses testifying for Reserve, with one expert witness and one minor fact witness testifying for the government. Rather than analyzing the expert and fact witnesses' testimony, the Court erred by relying on its own experiences and on an erroneous legal concept that was first announced in *Avrahami*.

The three main issues addressed by the Court in the *Reserve* Opinion, using *Avrahami* as its template, were as follows:

(1) whether **risk distribution** was achieved by Reserve, aided by its participation in a pooling arrangement, with **whether Reserve was an insurance company** (per the Court) being the threshold issue;

(2) whether Reserve's transactions were **insurance in the commonly accepted sense**; and

(3) the **tax consequences** taking into account the Court's conclusions with respect to each of the first two issues above.

Comparison/Contrast of the Issues Considered in Both Cases

A side-by-side comparison of each of the three main issues analyzed in both *Avrahami* and *Reserve* is included below. Each table shows the similar format between the two opinions. As discussed later in this article, the "shoehorn approach" employed by the Court in *Reserve* does not reflect an adequate analysis of the legal and factual issues presented.

A. Risk Distribution

Avrahami	***Reserve***
New "bona fide insurance company" requirement created for pooling arrangements: Court erroneously applied a new "bona fide insurance company" requirement (a 9-factor test) to the pooling arrangement to determine whether the captive distributed risk by participating in the pooling arrangement, erroneously citing to *Rent-A-Center*[16] which did not involve a pooling. No case or IRS pronouncement had ever previously required a pooling program to be conducted by a "bona fide insurer," which was simply assumed by the court. The *Avrahami* court announced this new 9-factor test had to be satisfied by the pooling arrangement "before it [could] say whether [a pooling participant] distributed risk through the [pooling] program." This prerequisite had never before been applied to a pooling arrangement.	New "bona fide insurance company" requirement followed with no analysis of IRS rulings on pooling arrangements: Court applied the same "bona fide insurance company" test (9-factor test) to the pooling arrangement to determine whether the captive distributed risk by participating in the PoolRe pooling arrangement, citing to *Avrahami* and *Rent-A-Center*.[18] The *Reserve* Court applied this new 9-factor test **retroactively** to the PoolRe pooling arrangement despite: (1) neither party presenting evidence on this issue at trial and (2) the *Reserve* trial concluding on May 2, 2017, more than 3 1/2 months **before** Judge Holmes issued the *Avrahami* opinion announcing this erroneous new requirement.
Among the "bona fide insurance company" factors discussed were: 1. Circular flow of funds • Court found this factor present since the "end result" was that the insured paid same amounts to Pan American as Pan American paid to Feedback in reinsurance premiums. "*While not quite a complete loop, this arrangement looks suspiciously like a circular flow of funds*."	Among the "bona fide insurance company" factors discussed were: 1. Circular flow of funds • Court citing to *Avrahami* found this factor present since the result under the quota share arrangement was that "Reserve would receive payments from PoolRe in exactly the same amount as the payments that PoolRe was entitled to receive from [the insureds] for the stop loss coverage." Court ignored that the risks underpinning the premiums were vastly different as were the parties receiving the funds: (a) Peak and the other insureds paid premiums to PoolRe for 11-14 policies for each year at issue, (b) In 2010 alone, PoolRe homogenized and blended 650+ policies from 200+ insureds, ceding a portion of these risks under the quota share agreement to Reserve.

Avrahami	***Reserve***
	• In fact, there was no "circularity of funds" because the parties are different; the *Reserve* Court conflated the three Peak insureds (each a separate taxpayer) with Reserve as insurer (also a separate taxpayer), ignoring the distinct corporate existence of these taxpayers. • Additionally, the Court ignored the separate corporate existence of the insured parties versus the participating insurers. **See discussion at pages 21-23 below**. Court appeared not to understand that given that this is a mutual pooling agreement, while the dollar amount of premiums is the same, that Reserve's risks associated with the premiums under the quota share agreement (being a percentage of the risks associated with 650+ policies from 200+ insureds) were wholly distinct from the risks insured by PoolRe for the three Peak insureds alone under the stop loss agreements with the Peak insureds (under 11-14 policies). The fact that the amount of premiums was the same is because this is how a mutual pooling arrangement works.
2. Lack of arm's-length contracts • Court found this factor absent since "If a covered claim came in, Pan American would have to go to each of the participating reinsurers to get the necessary cash; and if a reinsurer wouldn't or couldn't pay, Pan American would have to foot the bill itself." **The court's analysis of this factor was driven by Pan American being thinly capitalized and thus unable to pay claims**.	2. Lack of arm's-length contracts • Court found this factor absent and stated that "the perfect matching of payments under the corresponding stop loss endorsements and quota share policies (from the Peak insureds to PoolRe, and from PoolRe to the participating captives) indicates that the quota share arrangement was not the product of arm's-length considerations." The Court appeared to analyze the contractual relationships of the parties (PoolRe and the Peak insureds) but failed to understand them. The evidence didn't support the Court's finding. • **In contrast with *Avrahami*, where the pooling arrangement held little monies to pay claims, non-party PoolRe held 25% of premiums (in 2010 for example) as retention under 650+ policies and had the ability to call for additional funds. The Court did not understand the mutual pooling arrangement. See discussion at pages 23-26 below.**
3. Unreasonable premiums • Court found this factor present since the actuary pricing Pan American's terrorism policies "recommended a one-size-fits-all rate for each [participating captive]" and "charged the same rate to all of its participants regardless of their geographic location" and regardless of whether the terrorism policy "was written as an excess-coverage policy."	3. Actuarially determined premiums • Court contradicted itself within the Opinion. The Court concluded at p. 61 as follows: "Capstone calculated Reserve's premiums using objective criteria and what appear to be actuarial methods." Yet the *Reserve* Court also stated that "we are concerned with a one-size-fits-all rate for all the participants in the quota share arrangement," stating that "all participants in the quota share arrangement

Avrahami	*Reserve*
	agreed to direct their affiliated insureds to pay the same percentage of direct written premiums to PoolRe." These statements cannot be reconciled. • In making the "one size fits all" assertion the Court ignored the proof as to the proper pricing of all policies – being both the pooling arrangement (all aspects of such) and Peak insureds' policies with Reserve, with the IRS offering no contrary evidence regarding the pricing of Reserve's policies. **The evidence did not support this finding. See discussion at pages 26-29 below.** • The Court seemed confused about the relationship among the parties, perhaps because the Court in its Opinion tried to adjudicate issues not in controversy at the trial. The Peak insureds bought actuarially priced policies from their affiliated captives and paid an actuarially determined portion of the overall premium to PoolRe for a stop loss endorsement. • After homogenizing and blending premiums and associated risks for 650+ policies from 200+ insureds, PoolRe then ceded these premiums along with the Lyndon insurance to 58 separate and distinct insurers, including Reserve. 4. Faced actual and insurable risk • Court created a new standard eliminating the heretofore "fortuitous risk of loss" concept replacing it with a requisite of a history of losses and the exhaustion of all other (even unrelated insurance) policy limits as a condition of finding the existence of "insurance". **The evidence did not support this finding. See discussion at pages 29-31 below.** 5. Licensed and regulated as an insurance company • Court ignored affirmative evidence before it, which was not even objected to by the government, in concluding that PoolRe was not a licensed and regulated insurer in 2008-2009. **The evidence did not support this finding. See discussion at page 30 below.** 6. Created for legitimate nontax reasons • Court improperly concluded that "the only purpose PoolRe served through the quota share arrangement was to shift income from Peak to Reserve." In doing so, the Court ignored: (i) the payment of losses by Reserve of $339,820 to its affiliated insureds and an additional $187,891.99 payment of losses to third parties (totaling $527,711.99) during the three tax years; and (ii) the separate corporate existence and vastly different

Avrahami	***Reserve***
➢ **Conclusion**: Court found that Pan American pooling arrangement was not a bona fide insurance company, that the policies it was issuing were not insurance and that Feedback's reinsurance of those same policies did not accomplish sufficient risk distribution.[17]	contractual obligations of PoolRe. The **Court was clearly erroneous in reaching this unsupported conclusion. See discussion at pages 31-33 below.** ➢ **Conclusion**: Court found that PoolRe pooling arrangement was not a bona fide insurance company, that Reserve's quota share reinsurance policies with PoolRe were not bona fide insurance agreements and that the "purported" reinsurance agreements between PoolRe and Reserve did not allow Reserve to effectively distribute risk.[19]

B. Insurance in the Commonly Accepted Sense

Avrahami	***Reserve***
Five Factors Considered by Holmes Court Court applied a **five-factor test** (citing factors considered under previous case law) in deciding whether the captive insurance arrangement *looks* like insurance in the commonly accepted sense.[20] Each material factor is analyzed below: 1. Organization, operation, and regulation ➢ Court found this factor to be lacking, focusing on: (1) Feedback dealt with claims "on an ad hoc basis" and (2) Feedback invested only in illiquid, long-term loans to related parties and failed to get regulatory approval before transferring the loaned funds, and (3) the Avrahamis' insured entities made no claims against Feedback until two months **after** the IRS commenced its tax audit, resulting in the court suggesting that the captive was a "sham."	Same Five Factors Considered by Kerrigan Court Court applied **same five-factor test**.[22] Each material factor is analyzed below: 1. Organization, operation, and regulation ➢ Court found this factor to be lacking, ignoring the evidence that: (1) Reserve paid $339,820 in total claims to its affiliated insureds and an additional $187,891.99 to third parties (totaling $527,711.99) during the three tax years in issue, none of which were even alleged to be "ad hoc" as in *Avrahami*; (2) Reserve's investments were traditional investments of insurance companies, here being cash, bank deposits and publicly traded securities, with no loans to affiliates (let alone being unsecured and undocumented loans as was seen in *Avrahami*); and (3) claims were paid, were unrelated to any IRS audit as was the suspicion in *Avrahami*. The bona fide nature of the claims was unchallenged. ➢ The basis cited by the Court for its ruling did not match the issue at hand and was not argued by the parties below. **The Court improperly complained that Reserve relied on a professional management team who worked at the direction of Reserve's officers and directors.**[23] The Court was clearly in error in holding that the officer was not entitled to rely on a professional management team in conducting Reserve's operations despite Reserve's president's testimony that he hired a captive manager precisely to handle this specialized

Avrahami	*Reserve*
	work. To be sure, Anguilla and virtually every U.S. insurance commissioner mandates professional management in the form of a captive manager as a condition of licensing. ➢ **Court's focus on "lack of due diligence" disregarded testimony of Reserve's owner that he relied on the professional team to advise him on decisions relating to Reserve's operational matters**.
<u>3. Valid and binding policies</u> ➢ Court found this factor to be lacking, focusing on the fact that Feedback's polices had **contradictory terms** since they were indicative of both a "claims-made" policy (i.e., the claim must be reported during the policy period) and an "occurrence policy" (i.e., the claim must occur during the policy period).	<u>3. Valid and binding policies</u> There was no issue raised at trial as to policies' "contradictory" terms. In assessing this issue, the Court was clearly erroneous in criticizing Reserve's policies as being "cookie cutter" simply because Reserve's policies were based on "forms." A basic premise of insurance is that the contracts are based on tried, true and tested language, and that policy forms are developed to serve as benchmarks for analyzing and comparing policies developed by individual insurers.[24] The Court wrongly created a requirement that has no basis in fact that policy forms must be custom crafted to be considered "insurance." The Court (improperly) raised it *sua sponte* in the Opinion. To be sure, insurance is based on common policy conditions and widely vetted and utilized coverage language and other terms and conditions. Also, the Court erroneously concluded that the policies "were not reasonably suited to the needs of the insureds" without even a hint of this being an issue at trial. **The evidence did not support this finding. See discussion at pages 35-36 below.**
<u>4. Reasonableness of premiums</u> ➢ Court found this factor to be lacking, focusing on the fact that the actuary responsible for pricing Feedback's policies did not price the policies based on actuarially sound decision-making but aimed his pricing at **reaching a "target premium** of $1.2 million (the target) without going over.	<u>4. Reasonableness of premiums</u> ➢ Court concluded that the policies' pricing was actuarially sound and objectively determined. Opinion at 61. Yet the Court then found this factor to be lacking given that "the absence of a real business purpose for Reserve's policies leads us to conclude that the premiums paid for the polices were not reasonable and not negotiated at arm's length." **The evidence did not support this finding** and the issue as to, for example, why a manufacturer whose business is dealing every day in contaminated equipment and is physically located within a Superfund site would want pollution liability coverage (given that the answer

Avrahami	*Reserve*
	is obvious). The government did not question Peak's need for the pollution liability coverage or question why a manufacturer would want to have business interruption coverage for its operations conducted mainly at one facility which was covered by one of Reserve's issued policies. Nonetheless, the Court *sua sponte* raised these issues in concluding that there was no business purpose. **See discussion at pages 36-38 below**. To be sure, the Court in drawing upon *Avrahami* contradicted its own findings that the polices were actuarially priced and objectively determined.
(5) Payment of claims ➢ Court found this factor to be present, but it noted that the Avrahamis' entities only began filing claims against Feedback **after** the IRS began its audit of the captive arrangement.	(5) Payment of claims ➢ The Court ignored the uncontested testimony as to the payment of claims that Reserve made to both Peak as an insured ($339,800) and to third parties ($187,891.99) (aggregating $527,711.99) during the 3 years at issue. Despite the routine payment of claims, the Court did not give this factor much weight, stating that it did not regard [Reserve's claims payments] as "overwhelming evidence." What evidence can a Court demand as evidence of the payment of claims other than the payment of claims? The Court's standards are ever higher shifting.
• **Conclusion**: Feedback's transactions were not insurance in the commonly accepted sense.[21]	• **Conclusion**: Reserve's transactions were not insurance in the commonly accepted sense.[25]

C. Tax Consequences to the Parties Before the Court

Avrahami	*Reserve*
Taxability of Feedback's Revenue 1. Court held that Feedback did not qualify to make a Section 953(d) election or a Section 831(b) election since it was not an "insurance company" for federal income tax purposes."[26] 2. The parties stipulated that the "non-premiums" received by Feedback captive were **not taxable** income as "U.S. source fixed or determinable, annual or periodical income" under Section 881 or as income that is "effectively connected with a U.S. trade or business" under section 882.[27] Court held that Feedback was not subject to tax under Section 881 or Section 882, which govern the taxation of foreign corporations.	Taxability of Reserve's Revenue 1. Court held that Reserve did not qualify to make a Section 953(d) election since it was not an "insurance company" for federal income tax purposes."[28] 2. Court improperly held that the "non-premiums" received by Reserve captive were **taxable** under Section 881, simply stating that "Reserve bears the burden of showing that the income it received is not FDAP income as respondent determined in the notice. Court did not reconcile its holding as set forth in the motion for rehearing…. with the result recognized by both the parties and the Court in *Avrahami* or explain why the "non-premiums" received by Reserve were taxable under Section 881 as "U.S. source fixed or

	determinable, annual or periodical income." Nor did (or could) the Court reconcile this conclusion – indeed, it didn't even attempt to do so – with Reserve's payment of $527,711.99 in losses to insureds.
Effect on the Captive's Insureds • Court held that since the payments by the insureds of "non-premiums" to the Feedback captive weren't for insurance, they could not be deducted as ordinary and necessary business expenses under section 162(a).[29]	Effect on the Captive's Insureds • Since the insureds were not before the Court, the Court could not address the tax consequences to the insureds with respect to the payment of "non-premiums" by the insureds to the Reserve captive.

III. The *Reserve* Court Imposed Newly Announced Requirements for Pooling Arrangements

As a threshold matter, a pooling arrangement can be summarized as a risk diversification mechanism, with risk diversification being essential to the insurance concept of the law of large numbers.[30] The *Reserve* Court needed to and did address risk distribution as achieved by Reserve, which necessarily must include an understanding of the pooling arrangement's role. Pooling arrangements have been the subject of several IRS rulings, including a published revenue ruling,[31] which are at odds with the Court's holding that a "pooling arrangement" must be conducted only through a licensed "bona fide insurance company." The IRS is bound to follow its own precedent in the form of a published revenue ruling.[32]

An insurance pool is used to diversify the risks of an insurer by "pooling" or "blending" or "homogenizing" policies from many insureds.[33] An insurance pool may be based upon reinsurance arrangements wherein an insurer is reinsured for insurance risks or on insurance policies written to insureds. Pooling arrangements are contractual in nature whether documented as an insurance or contractual arrangement.[34] There is no industry norm or requirement for pooling to be done either contractually based on an insurance arrangement or simply through a cross contractual arrangement, with both leading to the same result. In the case of *Reserve*, the risk blending arrangement was performed through a licensed insurer, PoolRe, as an insurance arrangement. Reinsurance is simply insurance given to an insurer for underlying risks by another insurer.[35]

A. Court Applied a New Legal Standard to PoolRe, Creating an Uncontested Issue

The *Reserve* Court erred in creating what was otherwise a non-contested issue – whether PoolRe was a "bona fide insurance company." The Court erred in holding that a pooling arrangement must be carried out by an insurance company as an insurance arrangement, which of course is not and never has been the case. The Court, relying on and expanding *Avrahami*, but without regard to the fact that this was not an issue in *Reserve*, clearly erred in its conclusion. And as explained below, *Avrahami's* cite for this proposition to *Rent-A-Center* was in error in that *Rent-A-Center* never came close to addressing this issue.[36]

The Court misapplied a legal standard that had never previously been announced and cited to *Avrahami* to reach an erroneous conclusion on issues first raised in the *Avrahami* opinion months after trial testimony closed in *Reserve* on May 2, 2017. In doing so, the Court held that this newly created legal standard was applicable ***retroactively*** to Reserve.

At trial, The Wharton School's Dr. Neil Doherty, renowned insurance economist, testified that risk pooling arrangements like that of PoolRe are common in the insurance industry and that the particular arrangement between Reserve and PoolRe provided a level of risk diversification that "sailed" past that found in *Harper*, in which case he had previously testified and was cited by the court in that opinion in holding for the taxpayer.[37] The government offered no contrary evidence at *Reserve*'s trial.

In addition, industry expert Robert Snyder testified regarding the pooling arrangement administered by PoolRe that: (1) the "stop loss" and "reinsurance premium" structure employed in this pooling arrangement was a common insurance industry structure and a reasonable alternative so as to limit the liability of the "primary" insurer (i.e., a captive insuring one or more of its affiliates) by assuring the insured(s) of a source of funds to pay losses which may be in excess of the amounts that the primary insurer desires to retain[38] and (2) both the quota share and stop loss premium paid to PoolRe and the premiums ceded by PoolRe to the participating captives were reasonable.[39]

If the Court had conducted this analysis based on the facts before it, the Court would have had to cite to expert testimony from Dr. Doherty, which established each of the following facts:

(1) the policies issued by Reserve to the Peak insureds covered risks that are accepted as normal types of "insurable risk" and that those policies resembled those commonly encountered in the insurance marketplace,[40]

(2) by participating in the PoolRe pooling arrangement, Reserve insured the lower layer of its insurable exposures, with the higher layer of its insurable exposures being insured with an outside insurer (PoolRe) pursuant to a common insurance practice of layering risk,[41]

(3) by participating in the PoolRe pooling arrangement, Reserve's insured risks were commingled with insurable risks of more than 50 unrelated insurance companies,[42] and

(4) Reserve achieved even more risk distribution due to PoolRe pooling these commingled risks with the risks of many thousands of other unrelated parties by reinsuring the contractual liability associated with a large pool of risks.[43]

To be sure, the government's sole expert witness, Donald Riggin, readily admitted that at least 11 of the 14 policies underwritten by Reserve would be insurance policies covering legitimate risks if analytically based premiums could be established for such policies.[44] The government's witness acknowledged in his expert report that PoolRe provided the benefit of risk blending to each of the participating captives.[45] Yet the Court went outside the record in holding that PoolRe was not an insurance company and that none of the risks set forth in the case were insurance. In so holding, the Court failed to analyze or even address the exhaustive testimony of the experts holding to the contrary. The Court was clearly erroneous in its conclusions.

Despite this expert testimony from both sides and the fact testimony which only came from Reserve, the Court ignored the facts before it and molded the *Reserve* facts into *Avrahami*'s newly announced requirement that a "pooling arrangement" must be conducted only through a licensed "bona fide insurance company"[46] applying this newly announced requirement to *Reserve* on a retroactive basis, all while lacking factual support for Reserve not being an insurer. This requirement has no precedent in insurance law or practice.

Further, despite PoolRe not being a party to the *Reserve* case and despite this not being an issue in controversy, the Court made this a central tenet of its Opinion. In establishing this new requirement, the *Avrahami* court erroneously cited to *Rent-A-Center*[47] for the proposition that a pooling arrangement must be conducted through a "bona fide insurance company." However, a pooling arrangement was never addressed in that case since *Rent-A-Center* did not involve a pooling arrangement.[48]

All were ignored in the *Reserve* Opinion, which held in the face of the overwhelming testimony above that PoolRe was not an insurance company. The evidence presented at trial with respect to each factor considered by the Court (in determining whether PoolRe was a bona fide insurance company) is discussed later in Section V(A) of this commentary. As that section explains, Reserve carried its burden in establishing that PoolRe is a bona fide insurance company and that it participated in a bona fide pooling arrangement. Not only did the *Reserve* Court impose this newly minted requirement that a pool must be a "bona fide" insurer, but the Court also reached an erroneous conclusion in the face of clear evidence with respect to each factor that it discussed in applying this newly crafted test to pooling arrangements.

B. The IRS Ignored its Own "Look-Through" Concept

IRS rulings have consistently recognized a "look-through" concept with respect to insurance (including pooling and reinsurance) arrangements, whereby risk distribution is analyzed by "looking through" to the underlying risks in a pooling arrangement.[49] The concept of applying a "bona fide insurance company" test to a pooling arrangement was newly announced in *Avrahami* with that court not citing a valid precedent for its position. As previously discussed, the *Avrahami* court erroneously cited to *Rent-A-Center* for this proposition. The Court failed to apply the "look-through" concept and in so doing failed to examine the origins of the pooled risks to determine if participation in a pooling arrangement achieved sufficient risk distribution. Further, the Court erred in rejecting long-standing insurance practice providing that a pooling or risk diversification arrangement may be done contractually (whether or not by an insurer) or alternatively as an insurance arrangement. The question in all cases is whether the underlying risks diversified were insurance risks.

The Court in *Reserve* confused whether PoolRe must be a "bona fide" insurance company with what should have been the Court's focus, such being whether the risks diversified through the pool (being the 650+ policies insuring 200+ non-affiliated insureds) are insurance risks.

However, here again, the *Reserve* Opinion fails in that whether PoolRe is a "bona fide insurance company" was not an issue at trial and, prior to its creation in *Avrahami*, was never a requirement for a pooling arrangement. The *Reserve* Court's imposition of a requirement that a pooling arrangement be done only through a "bona fide insurer" finds no support in law or in practice. This fact is so clear that the government didn't put forth this argument at trial. Under the IRS's longstanding look-through concept, the examination of risk assumed looks through to the ultimate source of the risk. Thus, the question before the Court in *Reserve* should be whether the 650+ policies insuring 200+ insureds on a quota share basis by Reserve were policies of insurance covering insurable risks. This question was answered in the affirmative by Dr. Neil Doherty, who opined in his expert report that: (a) the policies in place for each captive participant (in the PoolRe pooling arrangement) covered losses to policyholders with respect to risks from the occurrence of fortuitous events and (b) these types of policies were routinely offered by the insurance industry.[50] The government's sole expert, Mr. Riggin, did not controvert the expert testimony of Dr. Doherty that the risks diversified through PoolRe were commonly insurable risks. Reserve carried its burden of proof on this issue, and no contrary evidence was offered by the government. Yet the Court misapplied the legal standard, creating an issue where even the litigants believed there was none and in so doing made a finding adverse to Reserve.

Given the look-through concept, the key question remains: "What are the nature of the underlying risks?" The relevant inquiry is whether the contractual rights being passed along via a pooling arrangement are insurance for federal income tax purposes.[51] Said another way, the inquiry from the insurer assuming the pooled policies is whether participation in the pooling provides the insurer with sufficient risk distribution.

The evidence presented at trial established both by factual testimony[52] and as summarized in Reserve's independently audited financial statements[53] was that PoolRe underwrote through its many stop loss agreements in 2010 (by way of example) over 650 separate policies, involving 58 different unrelated insurance companies that pooled risks with respect to policies that were issued to more than 200 non-affiliated insureds most of which were unaffiliated among themselves.[54] A similar program was conducted in 2008 and 2009. The total direct premiums written by PoolRe (which then reinsured these risks among the 58 unaffiliated participating insurers) in 2010 (for example) was $6,638,591.[55] Additionally, PoolRe assumed (and was ceded) $7,252,696 in premiums relating to risks from a publicly held commercial carrier, Lyndon Property Insurance Co.,[56] which PoolRe in turn ceded in large part to the 58 participating captives. No contrary evidence was offered by the government or the subject of objections by the government's sole expert, Riggin. Without (i) PoolRe being before the Court, and (ii) without the IRS presenting any evidence as to whether PoolRe was a bona fide insurance company, and despite its being licensed and supervised by a UK territory dating back to its formation in 2001, all with the uncontroverted testimony being that the UK Territory of Anguilla's insurance regulatory laws being typical of a proper captive domicile,[57] the Court *sua sponte* raised the "bona fide insurance company" issue and then erroneously concluded that non-party PoolRe was not a bona fide insurance company, which the Court had erroneously concluded was a requirement. The Court concluded that Reserve hadn't carried its burden on what was a non-issue. Not only was this mixed question of fact and law against the great weight of the evidence, but the Court's holding was clearly erroneous factually and legally on this uncontested issue even absent an appropriate *de novo* review.

The testimony by Dr. Doherty that PoolRe achieved a level of risk diversification that "sailed" past the threshold that had been established almost twenty years ago in *Harper*[58] was not the subject of any contrary evidence offered by the government at trial. Even the Court concluded, albeit reluctantly, that Reserve's premiums were calculated using objective criteria and actuarial methods.[59] It is not possible to reconcile this conclusion with the Court's holding that PoolRe's risks were not insurance risks. It should be easy to recognize as a matter of law a properly priced pollution liability policy is by definition an insurance policy and that for a deep mining equipment company operating its manufacturing facility in a Superfund site, the business purpose for such coverage is obvious.

At the same time, as discussed below, numerous witnesses affirmatively proved up that PoolRe was an insurer despite this not being a contested issue at trial.

Despite the unchallenged evidence by Dr. Doherty regarding the risk diversification afforded through a combination of the pool, the direct written policies and the third-party coverage through Lyndon, the Court erred in not concluding that the premiums were for insurance. The Court's reasons for such a conclusion were based on vague and ill-developed assertions ignoring the testimony as to how the policies of each insured were developed and priced. The Court asserted that a "one-size-fits-all" rate existed in terms of policy pricing,[60] but this is not supported by the evidence of the four actuaries or from the underwriter, Lance McNeel, CPCU. In reaching this conclusion, the Court inherently contradicted itself given it also held that the premiums charged for Reserve's direct written policies were priced "using objective criteria and what appear to be actuarial methods." Both situations cannot be present. The testimony of Reserve's insurance underwriter (McNeel) was that the policy pricing for each of Reserve's direct written policies was developed uniquely based on its own facts,[61] and no contrary evidence was offered by the government. McNeel further testified that each unaffiliated captive's policy pricing was implemented taking into account multiple individual factors by using the same risk-adjusted pricing methodology ***prior to the blending of each captive's risks and premiums taking place pursuant to PoolRe's quota share arrangement***.[62]

Section V(A) of this commentary summarizes the evidence presented at trial with respect to each factor that the Court addressed in finding that PoolRe was not a bona fide insurance company.

The fact that the blended risks of non-party PoolRe were ceded to 58 participating captive insurers unaffiliated with PoolRe was brushed aside by the Court and never analyzed perhaps because PoolRe was not a party to the underlying litigation. However, this did not hinder the Court in making findings against PoolRe. In doing so, the Court acted improperly.

The Court's dismissiveness also included ignoring PoolRe's assumption of insurance obligations with respect to a pool of contractual liability risks originally underwritten by a publicly-held insurance company (Lyndon), which PoolRe in turn ceded to the 58 participating captive insurers and others pursuant to an industry standard "quota share" reinsurance arrangement. The Court concluded that these contractual liability risks were also “not insurance” despite expert testimony and evidence of the reinsurance arrangement (referencing the underlying Lyndon insurance contracts) being admitted at trial.[63] The government provided no evidence whatsoever to dispute the validity of the Lyndon originated contractual liability insurance. The Court erred in concluding that these were not insurance contracts and reached this erroneous conclusion despite the testimony of the actuary and owner of the reinsurer ceding the Lyndon coverage to PoolRe that these ceded obligations to PoolRe were insurance.[64] Dr. Doherty’s expert testimony also confirmed the industry-typical mechanics of this PoolRe coinsurance and ceding arrangement as well.[65] Again, the Court made a conclusion contrary to the only evidence before it on this issue.

There is no prior law that imposed the requirement that a pooling be an insurance arrangement. Even the government conceded this point in its rulings and other pronouncements prior to the Tax Court’s decision in *Avrahami*.[66] Yet Judge Holmes failed to cite to any of these authorities when he introduced this anomalous concept in *Avrahami*, which was then relied upon by the *Reserve* Court, erroneously citing to *Rent-A-Center* for support.[67]

Despite Judge Kerrigan applying this new requirement to the pooling arrangement administered by PoolRe, the evidence at trial demonstrated that PoolRe’s activities in fact were those of a bona fide insurance company licensed by a territory of the United Kingdom during all years in issue, despite the Court’s conclusion to the contrary.[68]

IV. The *Reserve* Court Misapplied *Avrahami* Despite Fundamental Differences

In its attempt to mold the facts in *Reserve* into the holdings in *Avrahami* opinion, the Court did not analyze numerous key differences between the two captive insurance arrangements, some of which are summarized in the table below.

Contrasting the *Avrahami* Facts with the *Reserve* Facts

Avrahami	***Reserve***
There was only a single policy (terrorism) being pooled or blended as part of the captive insurer’s risk diversification program. The court concluded that this terrorism policy was significantly overpriced because its pricing was not determined with reference to the location or risks insured.[69] Rather, the pricing was to achieve a tax objective.[70] The terrorism policy seemed to duplicate a commercial insurance policy that had been priced at a fraction of the captive’s policy.[71] The Court found the actuary not credible.	There were over 650 policies (in 2010) offering a diverse range of different coverages for more than 200 different insureds within PoolRe which ceded coverage to Reserve among a total of 58 participating insurers under the quota share agreement. Reserve’s insurance manager obtained pricing indications for each direct written policy from an unrelated regional managing general agent (MGA), which opined on the price that the MGA would charge for the policies. These pricing indications formed the basis for the pricing for each policy issued by Reserve. All other captive participants in PoolRe received similar pricing indications from

Avrahami	*Reserve*
	the MGA, which formed the basis for pricing each captive's direct written policies. Finally, two independent actuaries testified that the pricing of each of Reserve's direct written policies was reasonable. The government offered no actuary or other expert regarding the pricing of any policy. The government's sole expert witness specifically said he was offering no opinion on pricing.
Only one risk (terrorism risk) insured by the captive was pooled and distributed via a pooling arrangement.	Reserve assumed risks on 650+ policies from 200+ insureds pooled or blended via the PoolRe pooling arrangement[72] along with Reserve assuming additional insurance risks from a public-held insurance company (Lyndon) under a ceding or retrocession arrangement.
The terrorism policy issued by the pool was "grossly overpriced" and was redundant with commercial coverages. The court noted the duplicative nature of the single pooled terrorism policy, which had a target premium of $360,000 calculated at exactly 30% of the $1.2 million "premium ceiling" under §831(b), with the duplicative commercial insurance policy for terrorism in place that has a premium of only $1,500.	The government never offered any challenge to the premium pricing. Further, the *Reserve* Court conceded the appropriateness of the premium pricing finding that "Capstone calculated Reserve's premiums using objective criteria and what appear to be actuarial methods."[73] None of the direct written policies issued by Reserve were duplicative of any of the insureds' commercial policies (although the Court erroneously concluded otherwise).[74] Actuarial testimony provided support that each direct written policy was reasonably priced, with the government offering no contrary evidence.
Approximately 65 percent of the captive's assets were loaned on an unsecured basis to an entity owned by the Avrahamis' children, with the loaned funds then being immediately transferred to their parents' (that is, the Avrahamis') personal account.	Reserve made no loans. All investments were bank deposits and publicly held securities.
The Pan American pool was thinly capitalized with limited liquidity such that the pool did not have the financial wherewithal to pay losses for a covered terrorism event. The pool retained only 2.5% of premiums received even though there was still 6 months remaining until the end of the	PoolRe was not before the Court. The government offered no evidence on the bona fides of the pooling arrangement, which was raised *sua sponte* by the Court. The Court tried an issue which was not contested.

Avrahami	*Reserve*
policy period with respect to the terrorism coverage.	The testimony and evidence established that PoolRe had ample liquidity measured in millions for losses. The pool retained millions of dollars to fund payment of losses for any covered claim under the stop loss endorsements. For example, in 2010, PoolRe retained 25% of the total premiums that it received from insureds until a final accounting, settlement and termination of the risk pool occurred more than 180 days after the end of the one year policy period (at least 18 months after policy inception), with retained premiums being returned to participating captives only after the extended reporting period had lapsed and all claims had been settled.[75] And beyond such, each participating captive was fully liable for its pro rata share of losses, just as done in a Lloyd's of London arrangement.
Feedback captive dealt with claims "on an ad hoc basis" and claims were only filed after the IRS audit began.[76] The few claims that were paid by Feedback were approved despite being filed late and inconsistent with the terms of the captive's policy.[77]	Claims were paid by Reserve on its direct written policies (that is, to its affiliated insureds). A total of $339,820 to the Peak Insureds during the years at issue. Third party claims totaled an additional $187,891.99 (aggregating $527,711.99) during the 3 years at issue. All claims paid were according to the policies' terms, with (in the case of the Peak insureds) formal settlement documentation being fully executed.[78]
Both the insureds **and** the captive insurer were parties before the Court.	Only Reserve, the captive insurer, was a party before the Court. Neither the pool nor the Peak insureds were parties. However, despite these persons not being parties in the case, the Court nonetheless made findings against these non-parties.

V. Court's Findings in Applying *Avrahami* Factors Are Inconsistent with the Evidence

Finally, the Court in *Reserve* did not evaluate or was clearly erroneous in examining the evidence presented with respect to either of the two tests that the Court purported to apply.

The Court first purported to apply the previously discussed "bona fide insurance company" test and relevant factors to the PoolRe pooling arrangement. The Court then attempted to apply the "insurance in the commonly accepted sense" test and relevant factors to Reserve's direct written policies.

As discussed below, the Court's conclusions, with respect to both tests, were not consistent with the evidence at trial.

A. "Bona Fide Insurance Company" Test – Factors Addressed

Each factor that the Court discussed to determine whether PoolRe was a bona fide insurance company is analyzed below.

1. Circular Flow of Funds

In connection with evaluating the "circular flow of funds" factor, the Court stated:

> "***The end result for each tax year under the quota share arrangement was that Reserve would receive payments from PoolRe in exactly the same amount as the payments that PoolRe was entitled to receive from Peak and the other insureds for the stop loss coverage. In considering a very similar set of circumstances in Avrahami v. Commissioner, 149 T.C. at __ (slip op. at 68), we concluded that "[w]hile not quite a complete loop, this arrangement looks suspiciously like a circular flow of funds***."[79]

The Court's statements above evidence a fundamental lack of understanding of a mutual pooling arrangement. In every pooling arrangement, by definition, the premiums paid into the pooling arrangement equal the premiums ceded to the pool participants. This is what a pool does; it blends and distributes risk.[80] However, the risks associated with the premiums paid to the pool are wholly distinct from the risks associated with the premiums that the pool cedes to its participating insurers. The pool receives premiums from the Peak insureds for the Peak insureds' own risks. This was separately duplicated more than 200 times from other unaffiliated insureds which paid premiums to the pool for insurance coverage reflected in 650+ policies. The pool blended and homogenized these premiums (and related risks) and then ceded the premiums (and related risks) to each of the 58 unaffiliated participating insurers for these 650+ pooled polices. Calling this "a circular flow of funds" is a fundamental misstatement on multiple fronts.

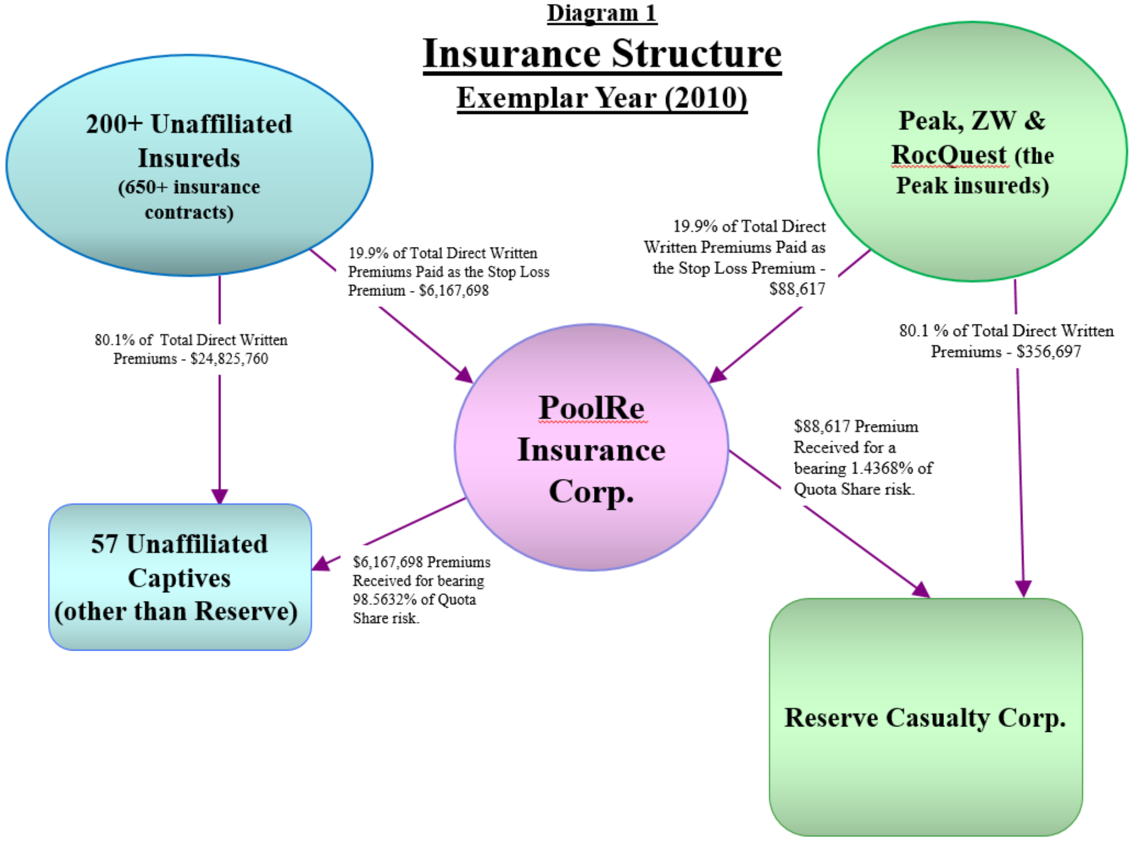
The Court chose to conflate the distinct and unaffiliated parties on its own, despite the evidence of the separate parties participating in the pooling arrangement not being challenged by the IRS with any contrary evidence. In doing so, the Court ignored the well-recognized, tax distinction among separate taxpayers whether or not affiliated.

See Diagram 1 below, which depicts the cash flows being exchanged pursuant to this mutual pooling arrangement (in 2010, for example).

Diagram 1

Insurance Structure

Exemplar Year (2010)



Connoting that Reserve, the captive insurer, is the same as the insureds ("***this arrangement looks suspiciously like a circular flow of funds***") without any explanation or analysis indicates the Court's failure to understand the corporate distinctiveness of the Peak insureds and the regulated Reserve as insurer as well as the unaffiliated insurers and unaffiliated insureds in the overall insurance arrangement. In effect, the Court suggested that a corporation and its pension plan trust are the same or that they constitute an improper circular flow of funds worthy of being disregarded despite the statutory basis for the arrangement. Similarly, as this Court would have it, an individual is denied a deduction to a Health Savings Account, despite its statutory existence, because the HSA and the individual are the same.

Indeed, the whole purpose of a captive insurance arrangement is to establish a separate but affiliated regulated insurance entity, the insurer, that participates in bearing the fortuitous risks of insureds. There is no prohibition or restriction that in any way prevents the insureds and insurer from being related. Indeed, in recent legislation, Congress, practically speaking, mandates that the insureds and the insurer have "mirror ownership" under the 2017 amendments to IRC Section 831(b)(2)(B).[81]

The Court's focus on the ownership of Reserve relative to the identical ownership of Peak insured's ignores the statutory provision and the existence of the diversified pooling arrangement comprising the risks under hundreds of unaffiliated policies assumed, the claims paid by Reserve to insureds for covered losses, the substantial funds retained by PoolRe during each policy year to fund potential losses, and the conditions that were required to be satisfied before any money could potentially be returned to the participating captives under the terms of the quota share arrangement with respect to the stop loss coverage provided by PoolRe. In doing so, the Court conflated Reserve, the regulated insurer, with the Peak insureds, ignoring both the form and substance of the transaction. In *Reserve*, the Court chose to cast aside an expressly provided statutory provision (Section 501(c)(15)). This same Court has recently been criticized and reversed (by two separate appellate courts) for its attempt to ignore express legislation authorized by Congress and attempting to apply its version of "substance over form" to transactions where a taxpayer complied with express provisions authorized by Congress.[82]

In terms of risk diversification, Dr. Doherty's testimony made clear that PoolRe's role was to insure the higher layer of losses which gives each participating captive a comfortable "safety net" to remain financially viable despite the fortuity of a large covered loss.[83] No witness suggested a different purpose.

Robert Snyder also testified at trial that PoolRe's pooling and quota share arrangement is a common reinsurance arrangement.[84] Nonetheless, the Court, without citing to any evidence to support its finding, erroneously accepted the government's contention that PoolRe's common quota share arrangement only provided "the appearance of risk distribution without actually distributing any risk."[85] *See also* a recent article published in Captive Review by reinsurance expert Oliver Schofield, commenting that the PoolRe pooling arrangement was an effective reinsurance structure for achieving risk distribution. Mr. Schofield explained that captive reinsurance is well established as an effective way of ensuring that captives do not "end up in the mortuary chapel" and emphasized that the reinsurance structure for a captive "should be [recognized] as being critical to a captive's longevity."[86] Insurance treatises and scholarly articles have long recognized the role of captive reinsurance[87] and its common usage of "stop loss" reinsurance or "excess of loss ratio" reinsurance arrangements as a means of controlling the loss ratio of an insurance company participating in a reinsurance pool.[88] All the meanwhile, none of the fact or expert witnesses testified on or even suggested the criticism of the pooling arrangement that the Court developed on its own, controverting all of the witnesses by erroneously citing to the facts that were present in *Avrahami*.

In summary, the Court erroneously concluded that insurer Reserve and the hundreds of insureds were one and the same, with the result that a "circular flow of funds" existed.

2. Arm's-Length Contracts

In analyzing this factor, the Court stated as follows:

> "***The perfect matching of payments under the corresponding stop loss endorsements and quota share policies (from insureds to PoolRe, and from PoolRe to captives) indicates that the quota share arrangement was not the product of arm's-length considerations. Peak's risks that were insured through PoolRe were different from the risks that PoolRe ceded to Reserve under the quota share policies. The risks that***

PoolRe purported to assume under the stop loss endorsements related to various unrelated business activities and to policies covering various unrelated lines of insurance. Reserve has not shown that the risks were comparable in scale."[89]

In the first instance, the Court has *sua sponte* raised a non-litigated issue involving non-parties, being the Peak insureds, and PoolRe. The Court is asking how the risks that PoolRe underwrote for the Peak insureds "were comparable in scale" to the risks that Reserve assumed from PoolRe without any explanation or analysis of what the Court means by this newly minted concept.

In doing so, the Court brushed aside the testimony of Reserve's experts on this matter even though the government offered no contrary evidence. The unchallenged evidence before the Court was that the stop loss endorsements between the non-party insureds and the non-party pooling arrangement were *contracts between independent and unaffiliated parties*. Despite the government not challenging either the stop loss or the quota share arrangements or their pricing, prima facie evidence was before the Court as to the arm's-length pricing of such between these independent and unaffiliated parties. Additionally, the pricing of Reserve's policies and the pricing of PoolRe's stop loss and quota share arrangements were supported by multiple actuaries,[90] plus being supported by pricing indications received by Capstone from a regional managing general agent (MGA) for each policy underwritten by each captive that participated in the pooling arrangement.[91] While the Court never further developed its newly articulated demand for a showing that risks were "comparable in scale," the evidence was before the Court if it wished to examine such.

Pricing support for the policies underwritten by Reserve and PoolRe included (a) Capstone procuring pricing indications from the Lloyd's of London MGA in connection with the pricing of each captive's policies,[92] (b) Capstone engaging an additional actuary (Glicksman) to determine the appropriate percentage of each captive's gross premiums to be allocated to PoolRe for the stop loss coverage,[93] (c) as discussed further below, the contemporaneous work of a CPCU underwriter, and (d) an after-the-fact examination by two independent actuaries. The collective support received from these several groups of insurance professionals on the pricing of the policies gave each unaffiliated pool participant additional assurance that the otherwise arm's length quota share arrangements were properly priced, which inherently considers that the reinsured risks were comparable in scale to one another on a price-risk adjusted basis. That is, the higher risk is compensated for by a higher priced policy for a given level of coverage.

The Court's conclusion to the contrary regarding policy pricing is clearly erroneous. In the face of voluminous testimony from Reserve's experts on pricing issues, the government's sole witness demurred, declining to address pricing.

The totality of the risks absorbed by PoolRe from the 650+ policies (each of which McNeel testified were priced using the same risk-adjusted methodology as was used for Reserve) were ceded or redistributed to the 58 participating captives. See Diagram 1 ("Insurance Structure – Exemplar Year") on page 22 showing PoolRe's premium blending structure. The input from the 200+ insureds in terms of payments to PoolRe under the stop loss arrangement resulted in the output, being the ceding of the stop loss premiums through the quota share agreements to the 58 captive participants. The ***risks in*** were the same as the ***risks out***, however, borne after distribution by 58 insurers. The input matched the output. The scale of risk was the same. The objective of the pooling arrangement is to homogenize and blend risk, redistributing the same among the 58 participating captives.

The Opinion reflects the Court's confusion as to how a risk reinsurance pool operates. In summary, risk pooling affects the exchange of an insured's/insurer's own risk for a percentage of the combined risks of all pool participants.[94] Captives as well as commercial insurers participate in risk diversification through pools for various reasons, including: (1) diversification of its underwriting portfolio, (2) reduction in the variability of retained captive losses by trading its own losses for a smaller portion of a larger pool of more diversified losses, (3) likely leading to the stabilization of cash flow, and (4) access to third party premium in further support of a captive's status as an insurance company for tax purposes.[95]

What the Court referred to above as a "perfect matching" of the dollar amount of payments (from insureds to PoolRe, and from PoolRe to captives) is a function of the fact that the total amount of insureds' premiums received by PoolRe were homogenized and blended and then ceded in total to the captives (including Reserve) pursuant to the quota share arrangement. The Peak insureds' relative participation level in the total pool of premiums determines the amount of premiums that PoolRe cedes to Reserve. In other words, assuming the proper pricing of Reserve's risks, which was testified to at trial, and which the Court concedes,[96] the dollar amount of Reserve's risks received from the Peak insureds should equal the dollar amount of the blended risks of the 200+ insureds which PoolRe then cedes to Reserve.

Underlying these same dollar amounts of premiums were vast differences in the contractual obligations associated with what was paid to the pool by the insureds (including the Peak insureds) relative to what was ceded to Reserve (and the 58 participating insurers) by the pool. PoolRe insured premiums from the Peak insureds, blending such with premiums from 200+ other insureds on 650+ coverages. In turn, PoolRe ceded to the participating insurers (including Reserve) a percentage of the overall blended risks. To call this "circular" is clearly erroneous.

Furthermore, the fact that hundreds of unaffiliated participants in the pooling program were willing to agree on the particulars of the quota share arrangement and corresponding stop loss endorsements indicates the exact opposite of what the Court suggests above. By agreeing to participate in the pooling arrangement, agreement was had by all that the risks of (for example, Reserve's) insured affiliates paid to PoolRe were in fact "comparable in scale" with the blended risks (of all other captive participants. The Court not only erred in its legal interpretation of the contractual provisions under the stop loss and quota share arrangements but was also clearly erroneous in its factual findings.

The large number of unrelated participants creates a presumption not rebutted by testimony (the government's expert expressly declined to provide any pricing testimony) as to the arm's length nature of the relationships among the many unaffiliated parties. The quota share arrangement was the product of arm's-length negotiations among the captive participants. The Court's finding that Reserve's premiums (charged to the Peak insureds) were calculated "using objective criteria and what appear to be actuarial methods"[97] was the result of voluminous testimony, including the unchallenged testimony of McNeel that the same process was followed for all other pool participants.[98] This should have fully resolved the Court's question that all policies and attendant risks were properly priced and a result of arm's-length negotiations. Implicit is that the policies' pricing accounts for the disparate risk exposures of the participants. That is, the cost of a pollution liability policy for the Peak insureds in Idaho is different from that of a pollution liability policy of an industrial cooling company in California.

The Court's conclusions cannot be reconciled with the unchallenged testimony at trial that each captive's direct written policies were based on pricing input from insurance professionals at Mid-Continent General Agency, Inc.[99] Thus, <u>each direct policy in the pool was already risk-adjusted and reflected an arm's-length price before any pooling of risks and premiums took place</u> via the PoolRe quota share arrangement. The Court also was clearly erroneous in not recognizing this fact.

The testimony at trial, for which the government offered no contrary evidence, included that once the indications were received by Reserve, the insurance manager's underwriter, himself a Chartered Property & Casualty Underwriter, would independently review and further develop premium rates based on these premium indications.[100] As with the MGA's pricing indications, every policy for every captive was individually-priced according to the risk exposures of the insureds by a Chartered Property and Casualty Underwriter, having as well the MGA's individual pricing indications on each policy for each participating captive.[101]

More specifically, the trial testimony demonstrated that, once the pricing indications were received by Reserve and its statutory insurance manager, the insurance manager's staff underwriter, McNeel, himself a CPCU, would independently review and refine premium rates based on these premium indications, taking into account multiple individual risk factors.[102] As with the MGA's pricing indications, every policy for every captive was individually-priced according to the risk exposures of the particular insureds by a CPCU, all along with the MGA providing individual pricing indications on each policy for each captive.[103]

Nonetheless, the Court raised issues *sua sponte*, demanding proof of the policy pricing of hundreds of other pool participants, which calls into question the Court's ruling. The Court's suggestion that the pool was not reflective of arm's-length pricing given the above was clear error and contradicted the Court's own conclusions as to the proper pricing based on the overwhelming evidence before it. The Court ignored the prima facie evidence that a pooling arrangement among hundreds of unaffiliated persons reflects an arm's-length transaction and, as discussed further below, ignored the obvious business purpose of non-party PoolRe.

3. Actuarially Determined Premiums

In evaluating this factor, the Court stated as follows:

"***According to a letter from Glicksman Consulting, LLC, to Capstone, PoolRe charges premiums that are a flat percentage of the gross direct written premiums. Reserve produced no evidence to support the calculation of the premiums. There is no evidence regarding the other Capstone entities that participated in the quota share arrangement which shows the industries and the risks involved and the specific amounts of exposure. According to the evidence, all participants in the quota share arrangement agreed to direct their affiliated insureds to pay the same percentage of direct written premiums to PoolRe. As in Avrahami v. Commissioner, 149 T.C. at_ (slip op. at 69), we are concerned with a one-size-fits-all rate for all the participants in the quota share arrangement***."[104]

As discussed above, McNeel's testimony addressed that the procedures followed for the Peak insureds mirrored that of all participants in the PoolRe pooling arrangement. Both Dr. Neil Doherty[105] and Mr. Robert Snyder[106] explained the pool arrangement at length, testifying that PoolRe operated an industry-standard pooling arrangement. The government did not controvert any such testimony or the conclusions of these experts. Yet, the Court went out of its way to discuss components to these experts' testimony that the Court (but neither the government nor Reserve) believed were absent.

The Court imagines some industry test is appropriate for a pool which is nowhere the case. The testimony before the Court was that the premiums of all policies were already risk-adjusted and already reflected an arm's-length price before any pooling of risks and premiums took place via the PoolRe quota share arrangement. Because this was the case, the main function of Glicksman as actuary for PoolRe (for the years in issue) and Myron Steves Insurance Solutions as consultant, was to advise PoolRe with respect to pricing given an attachment point for a given level of risk participation.[107]

As described above, the evidence before the Court was that premiums charged for each captive's direct policies – all 650+ of them – were already risk-adjusted before any pooling of risks and premiums took place in that each policy was individually priced following the same factors as were followed for the Peak insureds.[108] No contrary evidence was presented by the government, but this evidence nonetheless was cast aside by the Court. Thereafter, the function of the actuary for PoolRe, Steven A. Glicksman, was to calculate the percentage of the Peak insureds' (along with the other 200+ insureds') premiums to be paid to PoolRe for the stop loss coverage provided by PoolRe relative to the premium paid to the affiliated captive for the remainder of the risk borne by it. As is common in the insurance industry, risk is sliced and borne by parties having differing interests in differing tranches.

In contrast, the terrorism policy's premium in *Avrahami* was not priced based on the risk factors of the individual insureds (sales volume, number of employees, nature of the business, geographic location, etc.). In Peak, each of these factors was considered in pricing all of the policies. While not an issue in *Reserve*, the evidence before the Court was that all policies were individually priced based on factors unique to each insured and well supported by multiple professionals. In rejecting the trial testimony of fully accredited actuaries and others supporting the policies' pricing, the Court then made up its conclusions and contradicted its own findings that Capstone calculated Reserve's premiums "using objective criteria and what appear to be actuarial methods," leading to a clearly erroneous conclusion.

Among the Court's fundamental errors was its conflating (x) PoolRe's appropriate percentage pricing of the stop loss protection (with the stop loss pricing percentage applied against factors individual to the particular insured in question and its risks insured), with (y) Avrahami's pricing of the terrorism policy as a percentage of total premiums which did not account for any individual factors related to the terrorism risks insured (e.g., location and size of facilities)

Glicksman, a FCAS- and MAAA-accredited actuary, set the stop loss endorsement pricing as a percentage of the Peak insureds' total direct written premiums which the stop loss endorsement covered. This stop loss premium was then paid to PoolRe, ultimately being ceded to the participating captives under the quota share arrangement. These factors were illustrated in the report that was provided by actuary Glicksman to Capstone, which was accepted into evidence, with no contrary evidence being offered by the government at trial.[109]

Among the actuarial factors expressly considered by Glicksman in calculating the percentage of the combined premiums that were allocated and paid to PoolRe were: (a) the assumed expected loss ratio inherent in the rates charged by the underlying captives, (b) an assumed measure of variance, (c) an excess quota share loss ratio threshold, with losses above this ratio being covered, (d) an excess quota share percent, to indicate the percentage of losses above the excess loss ratio that are covered, (e) a load applied to risks in the excess layer, based on Mr. Glicksman's actuarial judgment, and (f) an expense and profit factor applied to risks in the excess layer.[110]

The Court was accurate in commenting that "all participants in the quota share arrangement agreed to direct their affiliated insureds to pay the same percentage of direct written premiums to PoolRe." However, the Court then rejected the actuarial basis for this arrangement. The Court's statement, while accurate, certainly does suggest that there was a "one-size-fits-all rate" being charged for all the participants in the PoolRe quota share arrangement because, as explained above, every policy had been individually priced with the individual premiums for each of the 650+ policies being uniquely determined, as explained above. No contrary evidence was offered by the government at trial. The fact that a percentage of these individually priced direct written premiums was then used to price, as is typical in the insurance industry, the stop loss endorsement, cannot yield a "one size fits all" conclusion.

The *Reserve* Court appeared to pull this "one-size-fits-all" language from the *Avrahami* opinion and then attempted to apply this term to the facts in *Reserve* (i) despite this never being a litigated issue at trial and (ii) despite the evidence presented in *Reserve*. The Court failed to analyze the evidence before it and was clearly erroneous in its conclusion.

The concern of a "one-size-fits-all rate" being charged for all the participants in a pooling arrangement <u>*may have been*</u> <u>*a legitimate concern*</u> of Judge Holmes in *Avrahami*. In *Avrahami*, the pooling arrangement (Pan American), which pooled the terrorism coverage, priced its terrorism policies without regard to relevant factors such as the insureds' geographic location and size or nature of operations. The traditional role of an underwriter, being to examine the pricing provided by an actuary for a line of business and then to make necessary adjustments to the coverages for a particular insured, was absent. In other words, no "underwriter's judgment" was being applied to the raw numbers that were provided by the actuary to reflect the different risk factors that applied to each of the pool's participating captives.

The facts of *Reserve* were in stark contrast to *Avrahami*. Each of the captive participants in the pooling program administered by PoolRe *had individually underwritten and priced policies*, with each policy being focused on the business needs of each insured. The unchallenged testimony and evidence established that the policies issued by Reserve to its affiliated insureds were individually underwritten[111] and the result of an on-site assessment reflected in a feasibility study.[112] The evidence presented at trial established that PoolRe's premiums *were actuarially determined,* as reflected in the report of actuary Glicksman. No contrary evidence was presented by the government. Each participating captive's premiums were based on a combination of the underwriting judgment of an experienced underwriter, who had in hand the pricing indications from independent MGA in connection with pricing the policies for each insured. Finally, two independent actuarial firms vetted the process and the premium amounts charged by Reserve for each of 2008, 2009 and 2010, concluding that Reserve's premiums were reasonable in amount. All of this was uncontroverted, with the government offering no contrary evidence.

In light of the above, the Court's several holdings cannot be reconciled with the Court's express conclusion that PoolRe's premiums were actuarially determined. Opinion at 61: "**Capstone calculated Reserve's premiums using objective criteria and what appear to be actuarial methods**."[113] By acknowledging this, the Court confirmed that PoolRe's premiums were also appropriately determined because Reserve's premiums included premiums ceded to it by PoolRe for the 650+ policies, following Glicksman's and Myron Steve's guidance.[114] No evidence was presented by the government at trial that any of the premiums at issue in *Reserve* were mispriced. All of the premiums in *Reserve* were reviewed by multiple levels of professionals, ranging from fully credentialed actuaries to CPCUs, underwriters and Lloyd's managing general agents.

The function of actuary Glicksman was to calculate the percentage of each insured's direct written premiums paid to PoolRe for the stop loss coverages which, once aggregated, formed the basis of the quota share program. For PoolRe to share risks among the 650+ policies, involving 200+ insureds and 58 captive insurers, each policy needs to be appropriately (that is, risk-adjusted) priced from the inception. The purpose of conducting a feasibility study for each separate insured business was to enable accurate policy pricing with respect to each captive that participated in PoolRe and to obtain MGA pricing indications of premiums for each participating captive in conjunction with conducting an underwriter's examination. In the case of *Reserve*, the policy pricing was additionally confirmed by actuaries Mead and Solomon. Despite the evidence before it, the Court appeared determined not to let the dissimilarities of *Avrahami* affect its holding.

4. Faced Actual and Insurable Risk

In evaluating this factor, the Court stated as follows:

"***The available history of losses for Peak and the other insureds shows that before the tax years in issue they never suffered any losses that would even come close to triggering the stop loss coverage provided for in the stop loss endorsements. PoolRe was removed far from any actual risk associated with the business or operations of Reserve's insureds***."[115]

The frequency (likelihood) and severity of the losses of the 200+ other insureds on the 650+ policies is what determines policy pricing. The loss history on the 650+ other policies was not before the Court as a litigated issue. And the Court had already determined that Reserve's policy pricing was objective and actuarially based. The testimony of Reserve's underwriter (McNeel) established that the same pricing methodology followed by Reserve was also followed for all other pool participants, with no contrary evidence being offered by the government.[116]

The Court's statement that the Peak insured's may not have suffered previous losses[117] in areas covered by Reserve's policies was highly unusual. This misconstrues the fundamental nature of insurance, being covering fortuitous (future) events. The Court's articulating the need for a past loss history as a prerequisite of insurance evidences the Court's fundamental misunderstanding of insurance. There has never been any requirement under case law for an insured to show a history of prior losses for a policy to qualify as insurance for federal income tax purposes or as a requisite to buy a policy. The Court's articulated standard is fundamentally in error and has no basis in law or in the insurance industry. The widely accepted standard for a risk to constitute an "insurance risk" for federal income tax purposes is that an insurance policy must insure against a "**fortuitous risk**" of future losses[118] rather than against the fear of a reoccurrence as misconstrued by the Court.

As discussed above in connection with the Court's "circular flow of funds" analysis, PoolRe was clearly not "removed far from any actual risk" insured. Additional evidence ignored by the Court that Reserve was not far removed from actual risks insured was the fact that losses were actually paid by Reserve (to both affiliates and third parties) in 2008 – 2010 for covered claims totaled $527,711.99.

The testimony was that all of the direct written policies in the pool were tailored to meet the needs of the insureds' business operations. In the case of Reserve, these were addressing the risks associated with supplying, maintaining and rebuilding life safety equipment (ventilation and flood control) for workers 5,000-8,000 feet underground, and supplying trucks manufactured by it for use in underground mining operations, with the Peak insureds' manufacturing facilities being physically located within a "Superfund Site." The table below shows the stark contrast between the risks pooled in *Avrahami* as compared to the diverse range of risks pooled in *Reserve*:

Pooled Risks	
Avrahami	***Reserve***
Terrorism coverage for three jewelry stores located in suburban Phoenix.	All of Reserve's direct written policies (shown below) <u>were jointly underwritten by both Reserve and PoolRe, with PoolRe then ceding its coverage among 58 unaffiliated insurers.</u> Product Recall Loss of Major Customer Intellectual Property Package Regulatory Changes Expense Reimbursement Loss of Services Weather Related Business Interruption Pollution Liability Tax Liability Directors & Officers Liability Punitive Wrap Employment Practices Liability Cyber Risk Legal Expense Reimbursement **Additionally, Reserve assumed the risks of 650+ policies covering 200+ unaffiliated insureds (2010).**

The Court's conclusion that PoolRe "was removed far from any actual risk associated with the business or operations of Reserve's insureds" was clearly erroneous and unsupported by the terms of the policies in evidence. To be sure, the Court's conclusion cannot be explained by the testimony. Further, the Court's arbitrary conclusion is at odds with its own conclusion that each of the policies at issue were actuarily calculated and objective determined.

5. Licensed and Regulated as an Insurance Company

The Court dismissed the uncontroverted testimony of two separate witnesses in stating that PoolRe "did not provide evidence that it was a licensed and regulated insurer before [it redomiciled in Anguilla starting on April 15, 2009]."[119] This was one of the many conclusions drawn *sua sponte* by the Court throughout the Opinion, which was not based on any evidence presented at trial or issues in controversy. As discussed at page 18 above,[120] PoolRe was a fully licensed and regulated insurance company for all years at issue, and the testimony of two witnesses at trial confirmed this fact, with the government offering no contrary evidence. Again, the Court was clearly erroneous in its conclusions.

6. Created for Legitimate Nontax Reasons

The Court stated regarding its view of PoolRe's business purpose:

"***The only purpose PoolRe served through the quota share arrangement was to shift income from Peak to Reserve. Reserve has not established that PoolRe was created or operated for legitimate nontax reasons***."[121]

Firstly, the Court is conflating any needed business purpose of Reserve with the need for the Court to examine the business purpose of PoolRe. As an initial matter, the Court requiring a business purpose of PoolRe is in error. Nonetheless, as explained at trial, the business purpose of PoolRe is to underwrite a variety of risks on behalf of each of its participants, which includes: (a) blending the risks of each captive participant, (b) underwriting the Lyndon unrelated third-party insurance on a for profit basis, and (c) investing its assets, seeking a profitable return.

Secondly, the Court is conflating any perceived need to examine PoolRe's business purpose generally with PoolRe's business purpose for administering this particular pooling program. While not an issue below, having only been raised erroneously by the Court, PoolRe is and has been an insurance company since 2003, having been found to be such by the government in 39 separate private letter rulings that were issued to captives that were participants in the PoolRe pooling arrangement.[122] There is no precedent establishing the need for a business purpose on a line of business by line of business basis (that is, for PoolRe's administration of this pooling arrangement as opposed to its other operations). The obvious business purpose for PoolRe conduct the pooling arrangement was to blend the risks of each of the pool's participants for the collective benefit of all of the pool's participants. The Court was in error on both of its conflated issues. To be sure, the Court failed to provide any cite for its newly created, *sua sponte* rulings. As discussed previously at page 13, a pooling arrangement may be implemented through an insurer as an insurance arrangement or may simply be a contractual agreement among the pool's members.

Thirdly, the government's sole expert witness, Donald J. Riggin, did not provide any testimony that the pooling arrangement was a sham or lacked a legitimate business purpose of distributing risk among the participating captives. In fact, Mr. Riggin admitted in his expert reports that the PoolRe pooling arrangement provided the benefit of risk blending (and risk distribution) to the participating captives. Mr. Riggin made each of the following statements in his opening expert report:

> "PoolRe Insurance Corp. ('PoolRe') is a virtual risk-blending construct. It holds no risk; it merely blends risk ceded from each Capstone captive, and then cedes all of it back to the individual captives from whence they came, pro rata based on the total premium amounts."[123]
>
> "PoolRe blends 18.5 percent of the premiums and losses; the individual captives purportedly each retain 81.5 percent, plus a blended share of PoolRe's risk. PoolRe also insures risk from entirely unrelated sources. The combination of the captive's individual risk plus the two types of unrelated risk results in a [70 percent/30 percent] breakdown between the captive's risk and the pooled, unrelated risk."[124]
>
> "If you pool a large number of heterogeneous risks, as does the Capstone program,

> and dole out loss payments irrespective of which risk was responsible for the loss, you have distributed the risk. . ."[125]

Mr. Riggin never argued at trial (in his testimony or in his expert reports) nor did the government that PoolRe failed to serve a legitimate business purpose, acknowledging that PoolRe served the valid business purpose of enabling the blending of risk among all of its participating captives.[126] Mr. Riggin did dispute (in his rebuttal expert report to Dr. Neil Doherty) that Reserve's participation in PoolRe was successful in effectively distributing *insurance* risk),[127] arguing that "homogeneity of exposure units" is necessary for an insurer to have the ability to develop loss development factors (LDFs) and calculate expected losses.[128] This argument was refuted by Dr. Doherty in his rebuttal report.[129]

Fourthly, PoolRe was a non-party below, and as such, its business purpose was not a litigated issue at trial. The government did not seek discovery from this non-party. For the Court to make a ruling by going outside the record against a non-party on a non-issue is clear error. No testimony or evidence supports the Court's position that the only purpose served by non-party PoolRe was to shift taxable income from Peak to Reserve. Nonetheless, before the Court was one of the business purposes of PoolRe, which was to provide the blending and pooling of risk which was not controverted. The Court erred both in reaching this conclusion and in imposing a requirement for the first time that non-party PoolRe had to demonstrate a nontax purpose either overall or on a line of business by line of business basis as a condition of Reserve being an insurer.

As discussed previously in Section I of this commentary, the Court was erroneous in finding that the Reserve insurance arrangement lacked a valid business purpose, and the Court's conclusion with respect to PoolRe's business purpose was likewise erroneous.

In summary, the evidence presented at trial did not support the Court's conclusions with respect to any of the factors that it purported to evaluate in applying the newly introduced "bona fide insurance company" test to non-party PoolRe's pooling arrangement.

B. "Insurance in the Commonly Accepted Sense" – Factors Addressed

After the Court concluded that PoolRe was not a bona fide insurance company and that the purported reinsurance agreements between PoolRe and Reserve did not allow Reserve to effectively distribute risk, the Court then considered an alternative ground for its holding that the transactions between Reserve and its insureds were not insurance transactions. This alternative ground evaluated 5 factors to determine whether Reserve's transactions were "insurance in the commonly accepted sense." Each factor discussed by the Court in making this alternative holding is analyzed below.

1. Organization, Operation, and Regulation

The Court stated as follows in its discussion of the organization, operation and regulation of Reserve.

"***Capstone managed both Reserve and PoolRe, and they were both parties to the quota share policies and the coinsurance contracts. Reserve contends that the reinsurance agreements allowed it to distribute risk. However, Reserve did not show that anyone with a financial interest in its operations considered the details of the quota share policies and the coinsurance contracts and considered whether 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***."[130]

"***In reality the interested parties to Reserve's insurance transactions did not participate in structuring or executing those transactions; little or no due diligence was performed with respect to the direct written policies or the reinsurance agreements; and for all of the tax years in issue only one claim was filed under Reserve's policies, and that claim was handled in an irregular manner. Capstone directed Reserve's activities and directed a series of transactions between its managed entities so that Reserve appeared to be engaged in the business of issuing insurance contracts. The facts establish that Reserve was not operated as an insurance company in the commonly accepted sense***."[131]

As reflected in the above two paragraphs, in finding this factor to be lacking, the Court focused on: (1) Capstone's directing Reserve's activities, (2) Reserve's owners not participating in structuring or executing Reserve's insurance transactions, and (3) the Court viewing there being "little or no due diligence performed" by Reserve's owners with respect to Reserve's direct written policies or reinsurance agreements.

The Court misstates the role of Capstone, which does not independently "manage" these companies in place of its owners. Capstone administers these companies on behalf of and at the direction of its management and board of directors.[132] Rather than focusing on the testimony of the relevant witnesses at trial regarding the operations actually conducted by Reserve, which its owners specifically engaged its captive manager to handle at the management's, board's and owners' direction,[133] the Court criticized Reserve for relying on Capstone with respect to its operational matters, implying that Reserve's owners must personally identify coverages, structure reinsurance transactions, diversify risk among third parties, etc., rather than drawing on a professional team. The Court imposed an unprecedented requirement that a captive owner must understand insurance and the captive program rather than drawing from professional advisors. The Court is imposing a higher standard on the captive-manager/captive-owner relationship than other usual and customary professional management relationships between an independent contractor and its client.[134]

In evaluating this factor, the Court brushed aside the testimony at trial that Reserve was both operated and regulated like an insurance company. The witnesses testifying regarding the organization, operation and regulation of Reserve included the following:

- Robert Snyder, an industry expert, who testified that Reserve's operations were consistent with those of a property and casualty insurance company operating in a domicile such as Anguilla, because Reserve was created, capitalized, and licensed in accordance with the regulations of that jurisdiction, and was at all times managed in accordance with sound captive insurance industry practice.[135]

- Steve Kinion, a regulatory expert and Director of the Bureau of Captive and Financial Insurance Products for the Delaware Insurance Department, who testified that Reserve was organized and regulated as an insurance company because: (1) Anguilla's insurance laws are within the norms for captive insurance laws; (2) Reserve was regulated in a manner consistent with Anguilla's laws; (3) Reserve's capitalization satisfied regulatory norms; and (4) the policies issued by Reserve transferred insurance risk.[136]

- David Liptz, a financial accounting expert, who testified that Reserve's use of insurance accounting was proper and that Reserve would be considered an insurance company for accounting purposes.[137]

In addition to disregarding the testimony of each of the above witnesses, the Court also disregarded the evidence before it with respect to what it considered to be perceived flaws in the claims process. The Court was incorrect in its finding that the claims payments made by Reserve in 2009 were "handled in an irregular manner." The Court was also incorrect in its finding that Peak did not submit and Reserve did not insist on any documents to substantiate the occurrence or the amount of the claimed loss.[138] The opposites are true. Claims paid by Reserve on its direct written policies totaled $339,820 and were paid according to the terms of the policy, with settlement release and documentation being fully executed in connection with each payment made to the insured under the terms of the policy.[139] The fact that Reserve adjudicated and paid a large claim filed by Peak is strong evidence that insurance existed in the commonly accepted sense.

2. Adequate Capitalization

The Court found this factor to be present since Reserve met the minimum capitalization requirements of Anguilla. This factor, while present, was apparently not given much weight by the Court.

3. Valid and Binding Policies

The Court found this factor to be "neutral" but criticized Reserve's policies as being "cookie cutter" policies, emphasizing that the policies were based on preexisting forms created and copyrighted by Capstone. The Court improperly concluded that Reserve's policies "were not reasonably suited to the needs of the insureds."

Evidence presented at trial demonstrated that the policies issued by Reserve were on forms common to the pooled policies in addition to being customized as needed.[140]

Form policies are ubiquitous in the insurance industry as are "forms" in the legal, medical and professional community generally. "Forms" do not lessen the legal impact of a contractual agreement. To be sure, forms exist in the insurance industry to facilitate the pooling and sharing of similar risks with respect to unaffiliated insureds under similarly contracted for coverages with similar definitions and other language and to achieve certainty on the scope of coverage. The Court appeared to call for an unrealistic approach in requiring that policies be individually manuscripted for each insured in order for those policies to qualify as valid and binding.

4. Reasonableness of Premiums

The Court stated as follows in its discussion of whether Reserve charged reasonable premiums to Peak for its direct written policies.

> "***With respect to premiums, the facts and circumstances of this case demonstrate that the direct written policies were not the result of arm's-length negotiations. Taking into consideration all the surrounding facts and circumstances, we conclude that no unrelated party would reasonably agree to pay Reserve the premiums that Peak and the other insureds did for the coverage provided by the direct written policies. Although Capstone calculated Reserve's premiums using objective criteria and what appear to be actuarial methods, the absence of a real business purpose for Reserve's policies leads us to conclude that the premiums paid for the polices were not reasonable and not negotiated at arm's length***."[141]

Based on the quoted language above and additional language in the Opinion, the Court appeared to conclude that premiums charged by a captive can only be reasonable if "it can be shown that the amounts agreed upon by the parties were the result of arm's length negotiations."[142] "Arm's length" connotes negotiations between unaffiliated parties. The Court's imposition of an arm's length requirement is meaningless in the context of a captive insurance arrangement. To be sure, nowhere in the Code or prior case law has there ever been a requirement of a "third-party" transaction in the captive insurance context. Rather, in many ways, a third-party transaction is incompatible with the purpose of a captive insurance arrangement, which is generally directed at transactions with affiliates.[143]

In *Harper Group v. Commissioner*, [144] the Tax Court had previously addressed the precise issue regarding permissible methods for setting reasonable premiums to be charged by a captive insurance company to its insured affiliates.[145] The premium rates charged by the affiliated captive in *Harper* "***were determined by reference to competitive pricing and other relevant factors***" gathered by the management of the petitioner Harper (and its domestic subsidiaries) in the course of their business and incorporated in the rates approved by the captive insurance company."[146] *Harper* noted that its "***rates were not determined by reference to actuarially determined loss projections***."[147] Still, the *Harper* court specifically held that the determination of the premiums in this manner was proper and concluded that the arrangements between the captive (Rampart) and its insured domestic subsidiaries constituted insurance in the commonly accepted sense.[148]

In *Reserve*, after considering the input and advice from various insurance professionals, including Mr. McNeel, a Capstone employee with substantial insurance and insurance underwriting expertise, and after considering data sources, including Mid-Continent's pricing indications received by Capstone (which represented the prices that Mid-Continent would charge for the same types of policies that were issued by Reserve), Reserve set the premiums for its direct written policies. Moreover, Dr. Neil Doherty, while not opining on the pricing results of Reserve's policies, viewed Reserve's pricing methodology as reasonable.[149]

Reserve's policies provided coverages for which loss data was not readily available to forecast potential losses. The evidence demonstrated that in the insurance industry it is not unusual that insurance policies be regularly written without readily available loss data to forecast losses.[150] Reserve also introduced the expert testimony of two actuaries, Ms. Mead and Mr. Solomon, who performed actuarial analyses and determined that the premiums that Reserve charged during the tax years at issue were reasonable in amount.[151] No contrary testimony on pricing was offered by the government.

Despite the above evidence presented by Reserve at trial and no evidence whatsoever being presented by the government regarding the legitimacy of Reserve's pricing methodology, the Court concluded that "the premiums paid for [Reserve's] polices were not reasonable and not negotiated at arm's length" and further concluded 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."

As previously discussed, in the context of a captive insurance arrangement, which is generally directed at transactions with affiliates, the insurance transactions entered into between a captive and its affiliated insureds, by definition, will usually not be "the [direct] result of arm's length negotiations." However, this fact alone does not justify the Court concluding that Reserve's premiums were unreasonable. <u>The Court must conduct a further analysis to determine whether the price charged for a transaction between related taxpayers produces an "arm's length" result</u>.

Reserve's evidence at trial demonstrated that the premiums charged were based upon independent third-party premium indications, themselves being arm's length pricing.[152] This methodology was then tested against two independently employed actuaries who reached the conclusion in their expert reports that the premiums charged by Reserve were reasonable.[153] The government did not offer any contrary evidence, choosing instead not to offer any pricing testimony. The Court, on the one hand, recognized that Reserve's premiums were calculated using "objective criteria and what appear to be actuarial methods" while at the same time inexplicably concluding that the premiums charged by Reserve were "not reasonable and not negotiated at arm's length."

The Court had no contrary evidence before it regarding the pricing of Reserve's policies. The only evidence presented regarding pricing was from Reserve, and the government failed to question pricing, presumably because it couldn't, given the overwhelming evidence presented in this regard by Reserve. The burden shifted to the government on this issue once Reserve introduced credible evidence establishing a prima facie case that the pricing of its direct written polices was reasonable.

5. Payment of Claims

The Court found this factor to be present, but did not give this factor much weight, stating that it did not regard Reserve's claims payments as "overwhelming evidence" that Reserve's policies constituted insurance in the commonly accepted sense. This comment by the Court cannot be explained given that the Court breezed over the evidence presented at trial with respect to each of the other factors previously discussed.

The Court stated as follows in its discussion of Reserve's payment of claims:

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

As discussed above in the context of the first factor regarding the organization, operation and regulation of Reserve, the Court disregarded the evidence before it with respect to what it considered to be perceived flaws in the claims process, and the Court was incorrect in its finding that the claims payments made by Reserve in 2009 were "handled in an irregular manner." The fact that Reserve adjudicated and paid significant claims (including both a $339,820 "loss of major customer" claim filed by Peak in 2009 and additional claims totaling $187,891.99 paid to third parties during the 3 years at issue) is strong evidence that insurance existed in the commonly accepted sense. The Court never explained what it considered "unusual" about the Stillwater loss paid.

In summary, the evidence at trial regarding the factors considered did not support the Court's conclusion that Reserve's transactions were not "insurance in the commonly accepted sense."

In conclusion, the Court's analysis in *Reserve* and its attempt to strictly follow *Avrahami* cannot be explained in light of the factual dissimilarities between the two cases. In this regard, *Reserve* is a dangerous precedent for the insurance industry and may indicate that the Tax Court has made a policy decision distinct from Congress. The Court's lack of analysis and reference to the evidence before it combined with the Court's molding of *Reserve*'s facts to fit within the template of the *Avrahami* opinion has drawn significant criticism from industry professionals and calls for a further examination of the case actually presented.[154]

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[1] 149 T.C. No. 7 (August 21, 2017).

[2] This issue concerned the inconsistency of the Court in finding that Reserve was subject to a withholding tax under IRC 881(a) in the face of its findings that Reserve had no business purpose for conducting its operations. Courts had previously held (and the IRS has previously concluded in revenue rulings) that, in

the case of lack of a business purpose, that a transaction between affiliated entities is treated as a nontaxable capital contribution. *See* Reserve's Motion for Reconsideration, which can be found here.

[3] The Internal Revenue Code of 1986, as amended, is referred to throughout the remainder of this commentary as either "IRC" or the "Code."

[4] The evidence presented at trial, which was ignored by the Court, included each of the following regarding the business purpose for the Reserve insurance arrangement:

1) the **feasibility study issued to Peak** prepared jointly by Capstone and Willis. *See* 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 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.

2) the **factual testimony of Norman Zumbaum**, owner of Peak Mechanical, who testified regarding Peak's need for policies issued by Reserve and Peak's inability to obtain commercial coverage for coverages such as pollution liability. 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." *See* Tr. at 123. Mr. Zumbaum also testified 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." *See* Tr. at 119-120. 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."

3) the **expert testimony of Robert Snyder**, who stated in his expert report as follows: "Reserve was a feasible and effective alternative risk management option for Peak and the Affiliated Businesses with respect to their insurance needs, because it served both to augment commercially obtained insurance that the entities carried and to cover fortuitous areas of risks inherent to their operations where there may have been gaps or inadequate commercial insurance market options. My opinion that Reserve was a feasible and effective alternative risk management option for Peak and the affiliated businesses is based in part on the Captive Insurance Company Feasibility Study - 2009, a copy of which is attached hereto…" *See* Exhibit 97-P (Expert Report of Bob Snyder, March 27, 2017), pages 1 and 2.

[5] See Opinion at pages 45, 57, 60, 61, 62. Each of the direct quotes below demonstrate the Court's erroneous perception that Reserve's insurance arrangement "lacked a legitimate business purpose":

p. 45 – "The only purpose PoolRe served through the quota share arrangement was to **shift income from Peak to Reserve. Reserve has not established that PoolRe was created or operated for legitimate nontax reasons**." (Emphasis added).

p. 57 – The Court erroneously found a lack of business purpose for Peak buying a pollution policy from Reserve, stating: "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).

p. 60 – The Court disregarded the testimony and evidence establishing Peak's need for each of Reserve's direct written policies, stating: "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).

p. 61 – "Taking into consideration all the surrounding facts and circumstances, we conclude that **no unrelated party would reasonably agree to pay Reserve the premiums that Peak and the other insureds did for the coverage provided by the direct written policies**. Although Capstone calculated Reserve's premiums using objective criteria and what appear to be actuarial methods, **the absence of a real business purpose for Reserve's policies** leads us to conclude that the premiums paid for the polices were not reasonable and not negotiated at arm's length." (Emphasis added).

p. 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).

[6] *See* Robert H. Jerry, II, <u>New Appleman on Insurance Law Library Edition</u>, Volume 1 – Essentials of Insurance, §1.09[1] (Overview). In this treatise, originally authored by John Appleman and recognized as a leading authority on the law of insurance, the author describes a captive insurance company as follows: "In recent years, a number of alternatives to traditional commercial insurance arrangements have appeared in the market in response to what have been difficult economic conditions. These are generally referred to as "alternative risk transfer" (ART) arrangements. **Captives, a special kind of insurance company established by a parent company, trade association, or group of companies to insure the risks of its owners, emerged in the 1980s when commercial insurance became scarce in some markets**." (Emphasis added). *See also* §1.09[3] (Captives) from the above cited Appleman treatise, where the author describes the general business purpose of a captive as follows: "Businesses sometimes form separate insurance companies to bear the risks of the parent company. These separate companies are called captives… [T]he captive has the potential to **produce lower insurance costs for the business than what might occur if the business purchases coverage from a commercial insurer**. There are a few thousand captives operating in the United States." (Emphasis added).

[7] 254 F.3d 1014 (11th Cir. 2001), rev'g TC Memo 1999-268.

[8] *Id*. at 1018 (Emphasis added).

[9] *Id*. at 1020 (Emphasis added).

[10] *See* Exhibit 104-P (Expert Report of Dr. Neil Doherty, March 27, 2017), page 16, where Dr. Doherty concluded as follows: As I have demonstrated earlier, using the nominal dollar amount of the premium allocation as a proxy can severely understate the amount of risk distribution when the related exposure placed in the captive is a predictable first layer of coverage, and the more risky higher layer is pooled with that of unrelated parties. This layered structure is an essential feature of the Capstone program… By layering its risk between its captive and PoolRe, each Capstone member would retain the more frequent and predictable losses (where the margin of error in estimating its cost of risk was low). But the larger and less frequent losses (as well as unusual accumulations of larger losses) would be pooled and thereby the risk would be tamed by the time it was reinsured back to the captive. This is a very efficient design for getting more "bang for the premium buck" out of risk distribution."

[11] 881 F.2d 247 (6th Cir.1989), rev'g in part and aff'g in part 88 T.C. 197 (1987).

[12] *See Humana*, 881 F.2d at 255 (6th Cir.1989). (Emphasis added).

[13] 62 F.3d 835 (6th Cir. 1995), rev'g 66 T.C.M. 1551 (1993).

[14] A Motion for Reconsideration of Findings or Opinion (pursuant to Rule 161) was filed in *Avrahami* by the Petitioners (the Avrahamis and Feedback Insurance Company, Ltd.) on September 21, 2017, and such motion was subsequently denied on November 14, 2017. The Petitioners in *Avrahami* did not file an appeal to challenge the decision of the Tax Court.

[15] One of the government's two witnesses merely proved up documents.

[16] *See Avrahami* at pages 66-76.

[17] *See Avrahami* at pages 75-76.

[18] *See Reserve* at pages 38-46.

[19] *See Reserve* at pages 45-47.

[20] *See Avrahami* at pages 76-86.

[21] *See Avrahami* at page 86.

[22] *See Reserve* at pages 48-62.

[23] *See Reserve* at pages 51-52, where the Court wrongly concluded that Reserve's owner could not rely on a professional management team and incorrectly concluded that Reserve's owner had little knowledge about Reserve's insurance operations, stating as follows:

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

[24] *See* Bonner, M., "*Insurance Services Office (ISO)*," updated September 2, 2018. This article can be viewed here and concludes as follows: "The Insurance Services Office, Inc. (ISO) provides statistical and actuarial information along with advisory services focusing on property/casualty insurance. Among ISO's offerings is policy writing. Creating new policy forms is a costly, time-consuming task. Insurers can avoid this task by using ISO forms. They can also avoid some risks associated with policy writing in that ISO forms have often been analyzed by courts. Many of ISO's policy forms are used as the industry standard, serving as benchmarks for analyzing and comparing policies developed by individual insurers. For example, the ISO Commercial General Liability Coverage Form is the industry standard for general liability coverage. Some insurers have developed policy forms that are broader than the ISO form."

[25] *See Reserve* at page 62.

[26] *See Avrahami* at pages 87-89.

[27] *See Avrahami* at pages 88-89.

[28] *See Reserve* at pages 62-66.

[29] *See Avrahami* at page 89.

[30] *See* Robert Shulman, *Reinsurance: A Primer for the Practitioner*, 3 L.A. Law. 34 (1980). Shulman explains a "reinsurance pool" as follows: "Often, when multiple insurers agree to reinsure, they do so by means of a 'pooling' arrangement. John Appleman, a leading authority on the law of insurance, has written that 'an insurance pool is a device used to spread the risk of almost certain loss among numerous insurers willing to accept the risk in limited amounts.' Those 'limited amounts' may be equal. For example, 50 reinsurers each may take a two percent portion of a part of a risk covered by reinsurance, with the balance retained by the ceding company. Conversely, as 'quota share' reinsurers, the pool members may accept such varying percentages of the reinsurance as they determine to be in their best interests. If the pool was constituted as an unincorporated association or other juridical entity and was itself a party to the reinsurance agreement, the pool itself may sue or be sued by the ceding company for the reinsurance proceeds. Alternatively, any or all of the pool members may be liable for the pool's obligations, although their liability *inter se* would be limited to a percentage of liability equal to the percentage of their participation, quota share or otherwise, in the reinsurance."

See also Hans Buhlmann & William Jewell, *Optimal Risk Exchanges*, 10 Astin Bull. 243, 245 (1979). Hans Buhlmann defines risk pooling as follows: "[A]ny formal mutual agreement among the '*n'* companies that, operating as an entity, (1) accepts the responsibility for paying for an input; (2) charges [companies] an output for accepting the input, according to the agreed-upon rule for sharing risks; and (3) operates on a zero-balance conservation principle." Buhlmann and Jewell explore general forms of exchange that result in simultaneous improvement of risk for all parties and describe various circumstances in which risk pooling might be beneficial for participants and for society relative to individual investment decisions regarding the management of security risk.

[31] *See* Rev. Rul. 2009-26, where the IRS held that risk distribution is analyzed by looking through to the underlying risks that are reinsured, which may be assumed under a contractual arrangement. That is, there was no requirement imposed that the risks must have flowed through or originated as risks of a "bona fide insurance company."

[32] *See Rauenhorst v. Commissioner*, 119 T.C. 157, 183 (2002), holding that when the treatment in a revenue ruling is favorable to taxpayers, the ruling is viewed as a concession by the IRS and is followed by the Court. *See also Beneficial Found., Inc. v. U.S.*, 8 C1. Ct. 639, 645 (1985) ("So long as a published ruling is not revoked or modified, it may be invoked by any taxpayer as if it were issued to him personally and, to the extent that it addresses issues in his case, this ruling will normally be dispositive." (footnotes omitted)).

[33] *See* Neil A. Doherty and Georges Dionne, *Insurance with Undiversifiable Risk: Contract Structure and Organizational Form of Insurance Firms*, Journal of Risk and Uncertainty, Vol. 6, No. 2 (1993), pp. 187-203. In this article, the authors explain that, "[For many different types of insurance], there has been a

proliferation of new firms such as mutuals, reciprocals, captive insurance companies, and risk retention groups. The essential feature of these organizational forms is that they are owned by their policyholders." *Id*. at p. 187. The authors further explain as follows: "[There was] a dramatic increase in the market share of the mutuals medical malpractice insurance market after the mid-1970s. A more dramatic example is the pollution insurance market, which all but disappeared in 1984-1985 only to show some signs of revival with the emergence of "mutual-like" pools organized by the major brokers. Similar innovations have also appeared in earthquake insurance. These structures share the common feature of combining the equityholder and policyholder functions, thereby allocating residual claims on the insurance pool to the policyholders. Risk is pooled amongst those who are commonly exposed rather than transferred to external risk bearers. *Id*. at pp. 187-188.

[34] *See* A.M. Best article, *Rating Reinsurance Pools*, October 13, 2017. This article can be viewed here. At page 3, the authors describe the structure of reinsurance pools as follows: "Reinsurance pools can be structured and governed in different ways. There are pools that are incorporated companies, licensed and registered within a jurisdiction and subject to local regulatory requirements, which operate in a similar manner to that of a reinsurance company. Conversely, there are pools known as policy issuing entities that may have no hard capital commitments and are based on the principle of reciprocal reinsurance, as outlined in a contractual agreement among members, the pool manager and its cedants."

See also Ernst & Young, *Study on co(re)insurance pools and on ad-hoc co(re)insurance agreements on the subscription market*, New Edition July 2014, pages 44-46. This study identifies **three main types of contractual reinsurance pooling arrangements** identified by respondents: (1) Collective agreements to assume risk, whereby an insurer (or an intermediary holding a delegated authority), rather than accepting in its own name an insurance or reinsurance risk of a defined type, accepts it in the name of and for the account of all of the participating insurers, the risk being shared between the members on a several basis, in accordance with the pool agreement; (2) Multilateral reinsurance contracts – this type of pool involves members reinsuring risks into the pool and accepting retrocession out again, possibly with the benefit of external retrocession arranged for the pool collectively; and (3) Broker-led arrangements (intermediary pools) – under this arrangement, brokers or authorized agents agree separately with insurers to take pre-agreed percentages of business sold by the intermediaries, potentially subject to acceptance by a lead insurer. Such arrangements are organized by the intermediary and not by the insurers. This study recognizes that "a pool is not restricted as to legal form, other than by the legal framework under which it is constituted" and identifies **three organizational forms for a reinsurance pool** identified by respondents: (1) a legal entity, (2) a multilateral contract, and (3) a statutory arrangement. According to the study, **the most common legal form for a pool is a "multilateral contract."**

[35] *See* Couch on Insurance, Third Edition, Chapter 9 (by successor authors, Steven Plitt, Daniel Maldonado, and Joshua D. Rogers), § 9:1 (June 2018 update), describing reinsurance as follows: "Reinsurance is a contract whereby one insurer transfers or 'cedes' to another insurer all or part of the risk it has assumed under a separate or distinct policy or group of policies in exchange for a portion of the premium. In essence, reinsurance is insurance for insurance companies. Reinsurance provides insurers with the ability to spread the risk that they have assumed, thereby preventing any one insurer from suffering a catastrophic loss. It also increases an insurance company's capacity to accept new risks, enables it to reduce required reserves, allows it to write risks that might otherwise be beyond its capacity, and permits greater competition among insurers. While reinsurance technically qualifies as insurance, it is a contract for indemnity rather than liability. Reinsurance has been in existence for centuries, during which time the industry was virtually unknown to all who were not intimately involved with the insurance business. Reinsurance has since received considerable attention following numerous natural disasters and the tragedy of September 11, which have resulted [in] billions of dollars in claims and numerous

insolvencies in the insurance industry. *Despite this fact, it remains a relatively unfamiliar area of law to most practitioners and members of the judiciary*." (Emphasis added).

[36] *See* Note 46 and Note 48 infra, discussing the facts of *Rent-A-Center* and the *Avrahami* court's erroneous citation to *Rent-A-Center*, which was a case that did not involve a pooling arrangement.

[37] *See* testimony of Dr. Neil Doherty, Tr. at 235-236 and Exhibit 104-P (Expert Report of Dr. Neil Doherty, March 27, 2017). In his expert report, Dr. Doherty stated as follows: "Given that most members of the Capstone program are medium sized firms (revenues of $10-$150 million), their loss histories would be rather sparse; especially for large losses which are quite rare. The data simply does not exist to provide such detailed estimation. However, it is precisely the rarity of large losses (compared with the frequency of small ones) which skews loss distributions and enhances the effectiveness of non-proportional stop loss programs in reducing risk. Thus, while I cannot give precise estimates of the degree of risk reduction achieved in this program, I can affirm that the qualitative aspects of this program suggest significantly more risk distribution than is implied in a simple (Harper) 70:30 split. **Accordingly, it would seem that, if Harper sets a general standard, then the Capstone members sail past this threshold. Furthermore, I believe that, because the Capstone program allocated the related-unrelated risk on a non-proportional 70-30 basis, it may achieve comparable risk reduction to that achieved in a proportional 49-51 allocation which would satisfy Rev. Rul. 2002-89**." (Emphasis added).

[38] *See* testimony of Robert Snyder, Tr. at 34-37. Mr. Snyder testified at pages 35-36 that "A quota share reinsurance policy is a policy that would typically be used by a reinsurance pool where a portion of the risks that are underwritten by other insurance companies -- in this case it would be captive insurance companies…that ceded to the quota share reinsurer proportionately, and the reinsurer then basically will cede back to the captive insurance company a small portion for that pool of risk. So the quota share refers to the proportionate percent, whatever it happened to be." Mr. Snyder further testified at page 36 that "In this instance the stop loss reinsurance agreement represented a specific proportion of risk that was underwritten by a captive insurance company that was… [jointly] provided directly by the reinsurer to the underlying insured. So a percentage of the business was placed directly with the joint stop loss reinsurer, and this terminology refers to that."

[39] *See* Exhibit 96-J (Letter from Myron Steves Insurance Solutions to PoolRe Insurance Corp., May 31, 2005, signed by Robert L. Snyder, Director, Risk Consulting) where Mr. Snyder stated: "The stop loss structure is one alternative, a reasonable one, in our view, to limiting the liability of the 'primary' insurer, and assuring the insured of a source of funds to pay losses which may be in excess of the amounts the primary insurer desires to retain. Other structures common to the insurance industry can be utilized to achieve a similar result, such as the purchase of primary insurance from one insurer, and direct excess (or "'umbrella" insurance) provided from another insurer on the same coverage terms as the primary. Alternatively, several insurers might share risk on a proportionate basis within the same layer of coverage on a 'quota share' basis… "The stop loss program, accordingly, is one of several acceptable approaches to limiting the risk retained by a particular insurer. In the PoolRe model, clearly most of the risk is retained by the captive insurer in the first instance, with the stop loss coverage applying upon the happening of various triggering events. The 81.5%/18.5% premium allocation is reasonable within this context, recognizing that in our judgment stop loss coverage in general might fairly be priced at anywhere from 2.5% to 30% of written premium."

[40] *See* Exhibit 104-P (Expert Report of Dr. Neil Doherty, March 27, 2017), page 27.

[41] *Id*. at pages 14-15.

[42] *Id*. at page 27.

[43] *Id*.

[44] *See* Appendix E of Exhibit 136-R (Opening Expert Report of Donald J. Riggin, March 27, 2017). *See also* Opinion at 61 where the Court found that Reserve's policies were actuarially determined and objectively based. The only 3 policies underwritten by Reserve that Mr. Riggin alleged to not cover certain legitimate insurable risks were the following 3 policies: (1) Special Risk - Loss of Services Insurance Policy, (2) Special Risk - Tax Liability Policy, and, (3) Excess Directors & Officers Policy. As to the other 11 policies underwritten by Reserve, Riggin conceded that these policies covered at least some insurable risks. *Id*.

[45] *See* Exhibit 136-R (Opening Expert Report of Donald J. Riggin, March 27, 2017), page 10, paragraph 30, where Mr. Riggin stated as follows: "PoolRe Insurance Corp. ("PoolRe") is a virtual risk-blending construct. It holds no risk; it merely blends risk ceded from each Capstone captive, and then cedes all of it back to the individual captives from whence they came, pro rata based on the total premium amounts."

[46] *See Avrahami* at pages 66-67. Judge Holmes incorrectly cited the *Rent-A-Center* case, 142 T.C. 1, 13 (2014), for the proposition that a pooling arrangement must be conducted through a "bona fide insurance company." However, *Rent-A-Center* did not involve a pooling arrangement and made no such finding. The tax court in *Rent-A-Center* did require *the captive* that was formed to insure Rent-A-Center (and its affiliates) to be a "bona fide insurance company," but the non-existence of a pooling arrangement in *Rent-A-Center* precludes the *Avrahami* or *Reserve* courts from extending the requirement of "bona fide insurance company" to a pooling arrangement.

In point of fact, *pooling arrangements are* often <u>contractual arrangements</u> among participants. *See* A.M. Best article, "Rating Reinsurance Pools," October 13, 2017. This article can be viewed here. At page 3 of this article, the authors describe the structure of reinsurance pools as follows: "Reinsurance pools can be structured and governed in different ways. There are pools that are incorporated companies, licensed and registered within a jurisdiction and subject to local regulatory requirements, which operate in a similar manner to that of a reinsurance company. Conversely, there are pools known as policy issuing entities that may have no hard capital commitments and are based on the principle of reciprocal reinsurance, as outlined in a contractual agreement among members, the pool manager and its cedants."

The widespread practices in the insurance industry necessitate both contractual pooling arrangements and pooling arrangements implemented through an insurance company. Nonetheless, as discussed in Section V(A) below, even though this was not a litigated issue at trial, the evidence presented at trial established that the pooling arrangement in *Reserve* was a bona fide, licensed insurer. The Court's findings regarding the presence or absence of each factor that it discussed in applying the "bona fide insurance company" test to PoolRe was not consistent with the evidence presented. As discussed below, Reserve carried its burden of proof with respect to each factor discussed by the Court, and the government failed to offer any evidence at trial to counter the proof offered by Reserve with respect to each factor.

[47] 142 T.C. No. 1 (January 14, 2014).

[48] *Id*. In *Rent-A-Center*, the Rent-A-Center holding company ("RAC") formed a wholly-owned insurance subsidiary, Legacy, for purposes of insuring workers' compensation, automobile and general liability risk

of RAC's operating subsidiaries. The IRS challenged the arrangement between the operating subsidiaries and Legacy on multiple grounds, including that the arrangement lacked requisite risk shifting and requisite risk distribution. The tax court in RAC disagreed, siding with the taxpayer. In determining whether payments to Legacy were deductible, the tax court stated in *Rent-A-Center* that "Our initial inquiry is whether Legacy was a bona fide insurance company. We respect the separate taxable treatment of a captive unless there is a finding of sham or lack of business purpose… Respondent contends that Legacy was a sham entity created primarily to generate Federal income tax savings." *Id*. at 10-11. The tax court considered each of the nine factors cited by the court in *Avrahami* and found that RAC presented convincing, and essentially uncontradicted, evidence that Legacy was a bona fide insurance company. *Id*. at 11-13. **However, no pooling arrangement was present in *Rent-A-Center*.** The "bona fide insurance company" test was only applied to the Legacy captive to determine whether Legacy was a sham or lacked a valid business purpose. *Avrahami* erroneously extended this "bona fide" test to the insurer on reinsurance assumed from third parties, which was then copied by the Court in *Reserve*.

Notably, the pooling or blending in *Rent-A-Center* was done by non-insurers directly purchasing policies through Legacy, without the benefit of the 650+ third-party policies seen in *Reserve* insured by PoolRe. Simply put, the *Reserve* Court conflated the "bona fide" insurance requirement imposed on Reserve with the chain of risks underwritten by it. Of course, the risks of Reserve need not be generated from other insurance companies: Reserve was insuring Peak, which is not and need not be an insurer, as well as insuring the risks of unaffiliated companies through PoolRe, which need not be an insurer, but was in this case.

[49] *See* Rev. Rul. 2009-26, PLR 201219011 (May 11, 2012), and PLR 201224018 (Jun. 15, 2012). These authorities are discussed in further detail infra at Note 66. Each of these IRS rulings clearly recognize that risk distribution is analyzed by "looking through" to the underlying risks that are reinsured, which may be assumed under a contractual arrangement, and none of these rulings impose a requirement that risk distribution flow only through "bona fide licensed insurance companies." In both PLRs, the IRS explicitly approved the use of quota share pooling arrangements to blend risks and did not require a reinsurance pool to be recognized as an entity or a "bona fide insurance company" to achieve risk distribution for federal income tax purposes.

[50] *See* Exhibit 104-P (Expert Report of Dr. Neil Doherty, March 27, 2017). Dr. Doherty opined at page 18, Section 2d (entitled "Insurable Risks") as follows: "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 [each of which are insured by affiliated captive participants in the PoolRe pooling arrangement] include a mixture of typical and specialized risk exposures. Policies of these types are routinely offered by the insurance industry." (emphasis added)

[51] In determining whether an arrangement is insurance for federal income tax purposes, courts apply the Supreme Court's definition of insurance in *Helvering v. Le Gierse*, 312 U.S. 531, 539 (1941) and its four nonexclusive criteria. To be considered insurance, the arrangement must: (1) involve risk-shifting; (2) involve risk-distribution; (3) involve insurance risk; and (4) meet commonly accepted notions of insurance. *See Rent-A-Center, Inc. v. Commissioner*, 142 T.C. 1, 13 (2014); see also *R.V.I. Guar. Co. v. Commissioner*, 145 T.C. 209, 225 (2015); *Harper Grp. v. Commissioner*, 96 T.C. 45, 58; *AMERCO & Subs. v. Commissioner*, 96 T.C. 18, 38 (1991), aff'd, 979 F.2d 162 (9th Cir. 1992); *Securitas Holdings, Inc. v. Commissioner*, T.C. Memo. 2014-225 at 18.

[52] *See* testimony of Stewart Feldman, Tr. at 753-754 and Exhibit 134-P (Pool Structure 2008-2010), which was used as a demonstrative exhibit by Mr. Feldman to explain the structure of the insurance arrangements between PoolRe and all of the parties that entered into insurance transactions with PoolRe (including the Peak insureds and Reserve). Mr. Feldman testified that "every policy that's accepted into [PoolRe] has a [stop loss] endorsement on the policy" and further testified as follows: "There's about – anywhere between 429 and 575 (for years 2008-2010) other insurance contracts from totally unaffiliated – generally from unaffiliated people out there throughout the United States that are also paying money in for stop-loss premiums at the same time. They're writing policies through their own unaffiliated captives. And as it affects PoolRe, money is coming [into] PoolRe for the stop-loss premium, about $30 million in a particular year. Let's just say it's $30 million. PoolRe takes all this money [received in the form of stop loss premium] and homogenizes it and blends it…and then sends back out a quota share of the overall [blended] risks that PoolRe has assumed from these 429 to 575 different [insurance contracts], from 150 affiliated insureds (for years 2008-2010) and sends [Reserve's quota share of the [blended risks] back to Reserve Casualty, and that's the 1.35 to 1.55 [percent] of the total premiums of PoolRe [received by Reserve in exchange for assuming its quota share of PoolRe's blended risks]."

[53] *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(a). In Note 2(a), the independent auditors' report received from Liptz & Associates, Inc. by Reserve attested to the fact that "[Reserve's] financial statements were prepared in accordance with and in compliance with accounting practices prescribed by [the] Anguilla Insurance Act and Regulations."

[54] *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) stated as follows: "[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 2010 risk pool comprises 650+ Stop Loss insurance contracts for 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."

[55] Source: PoolRe Insurance Corp., Audited Financial Statements – Statutory Basis, December 31, 2010 and 2009 and Independent Auditor's Report of Munninghoff, Lange & Co.).

[56] *Id*.

[57] *See* testimony of Steve Kinion, Tr. at 197-226 and Exhibit 103-P (Expert Report of Steve Kinion, March 26, 2017), pages 7-9. Mr. Kinion, the Director of Delaware's Bureau of Captive and Financial Insurance Products, testified that Anguilla's insurance regulatory laws are within the norms of insurance laws and that they are very similar to the captive insurance laws codified in many U.S. states, including Delaware.

[58] *See* Note 37 supra.

[59] *See* Opinion at page 61, where the Court concedes that "Capstone calculated Reserve's premiums using objective criteria and what appear to be actuarial methods" but then proceeds to conclude that the premiums paid for Reserve's policies "were not reasonable and not negotiated at arm's length."

[60] *See Reserve* at page 43.

[61] *See* testimony of Lance McNeel, Tr. at 356. Mr. McNeel testified that, for both Reserve and ***each other captive insurance company that was managed by Capstone***, "it was [his] practice to get a pricing indication from a company like Mid-Continent" that was unique to each such captive. (Emphasis added).

[62] *See* testimony of Lance McNeel, Tr. at 356-366. Mr. McNeel testified that the premium pricing for each type of coverage that was underwritten by Reserve Casualty Corp. for coverages provided to Peak Mechanical, as reflected on Exhibit 112-P (Reserve Casualty Corp. - Rating Worksheet for Peak Mechanical, Inc. for policy years 2008, 2009, and 2010), took into account multiple individual factors, including Reserve's premium indications (received from Mid-Continent General Agency, Inc.), 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 these factors.

[63] The Court refused to recognize the validity of a pool of contractual liability insurance policies that were issued by a publicly held insurer (Lyndon) or the existence of the related coinsurance contracts whereby Lyndon ceded a portion of the underlying pooled risk to PoolRe. At page 47 of the Opinion, the Court concluded as follows: "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." Yet there was no challenge by the government to the evidence presented by Reserve of the reinsurance contracts, which referenced the underlying Lyndon insurance contracts. This evidence was admitted at trial, and the government did not object to the admission of such evidence or call for a "best evidence challenge" or demand that the 100,000+ individual contracts be admitted rather than the reinsurance contracts that referenced the underlying insurance contracts.

[64] The only testimony regarding the existence of these coinsurance contracts was from actuary Gary Fagg who negotiated and administered this entire reinsurance arrangement and calculated the pro rata share of risk that was transferred to PoolRe for multiple years, including the years 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).

[65] *See* Exhibit 104-P (Expert Report of Dr. Neil Doherty, March 27, 2017), page 15, where Dr. Doherty stated 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 as depicted in Figure 2 attached. 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."

[66] In Rev. Rul. 2009-26, the IRS ruled that risk distribution is analyzed by looking through to the underlying risks that are reinsured, which may be assumed under a contractual arrangement. That is,

there was no requirement imposed that the risks must have flowed through or originated as risks of a "bona fide insurance company." The IRS has also issued two private letter rulings, PLR 201219011 (May 11, 2012) and PLR 201224018 (Jun. 15, 2012), whereby the IRS approved the use of quota share pooling arrangements to blend risks where the premiums ceded were roughly equivalent to the premiums for the blended risk assumed. In both PLRs, the company that requested the ruling, as a direct writer, received premiums from its insured and, pursuant to a coinsurance agreement, it ceded a quota share percentage of these directly written premiums to a reinsurance pool. *The company then assumed a quota share of the premiums from the reinsurance pool which were roughly equivalent in dollar terms to the amount it ceded on each line of insurance.* The IRS ruled that that the arrangement between the insured and the company constitutes insurance for federal income tax purposes and did not require the pool to be a "bona fide insurance company." In fact, the IRS specifically stated in these rulings that "no opinion has been requested and none has been expressed as to whether the reinsurance pool is an entity for federal income tax purposes."

[67] *See Avrahami* at pages 66-67.

[68] Two different witnesses testified to the fact that PoolRe was an insurance company licensed by a territory of the United Kingdom during all years at issue, and their testimony was unchallenged. *See* testimony of Bob Snyder, Tr. at 51-52. *See also* testimony of Lance McNeel, Tr. at 382. Both witnesses testified that PoolRe was a licensed insurance company (domiciled in the British Virgin Islands or and later domiciled in Anguilla) during all years at issue. The Court erroneously implied that, for 2008, there was no evidence of PoolRe's licensing.

[69] See *Avrahami* at page 69 of the slip opinion, where the court stated that "Pan American charged the same rate to all of its participants regardless of their geographic location" and "Pan American participants also paid the same rate even if they – like American Findings – had terrorism coverage under another policy, even though the TRIP policy was written as an excess-coverage policy, in which the risk assumed by Pan American was only the portion of a loss not covered, or not fully covered, by another policy."

[70] *See Avrahami* at page 85, where the court stated that "We find from all this that [the actuary's] calculations aimed not at actuarially sound decision-making but at justifying total premiums as close as possible to $1.2 million – the target – without going over. To do so he would add in a proration factor or drop the policy limits until he reached his goal."

[71] *See Avrahami* at pages 39-40, where the court stated that "In addition to its TRIP policy from Pan American, American Findings continued to buy add-on terrorism coverage – backed by the federal government in compliance with TRIA – from its commercial-insurance provider, Jewelers Mutual. The record shows that American Findings paid around $1,500 in 2009 and $1,600 in 2010 for this additional coverage. The Jewelers Mutual policy had a $2 million aggregate limit and specifically excluded coverage for chemical and biological hazards."

[72] *See* Exhibit 35-J (2008 Direct Written Policy Schedule for Reserve Casualty Corp.), Exhibit 59-J (2009 Direct Written Policy Schedule for Reserve Casualty Corp.), and Exhibit 74-J (2010 Direct Written Policy Schedule for Reserve Casualty Corp.). *See also* Exhibit 53-J (2008 Joint Underwriting Stop Loss Endorsement – Reserve Casualty Corp. as "Lead Insurer" and PoolRe as "Stop Loss Insurer").

[73] *See Reserve* at page 61.

[74] *See Reserve* at page 14, where the Court removed the following language from its quotation of 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 language 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.).

[75] *See* Exhibit 86-J (PoolRe Insurance Corp. – 2010 Quota Share Reinsurance Policy), page 6.

[76] *See Avrahami* at page 78, where the court stated that "We will not overlook the fact that the Avrahami entities made no claims whatsoever against Feedback from its inception in 2007 until March 2013 – two months after the IRS sent the Avrahamis documents about the audits of the returns of American Findings, Chandler One, O&E, and White Knight that suggested Feedback was a sham."

[77] *See Avrahami* at pages 78-79 of the slip opinion, where the court stated that "even the claims Feedback did receive it dealt with in questionable ways. Most of the claims were approved despite being filed late – the policies required that Feedback be notified within 30 days of the loss 'as a condition precedent to payment of any benefit hereunder.' And Heritor approved White Knight's claim for a new roof despite a lack of evidence about the cause of the damage."

[78] *See* Exhibit 89-J (check for claim payment to Peak Mechanical and Components, Inc. in amount of $150,000 on 4/21/09), Exhibit 91-J (check for claim payment to Peak Mechanical and Components, Inc. in amount of $14,980 on 5/27/09), and Exhibit 92-J (check for claim payment to Peak Mechanical and Components, Inc. in amount of $175,000 on 9/10/09. *See also* Exhibit 90-J (Settlement and Release Agreement Between Reserve Casualty Corp. and Peak Mechanical and Components, Inc. executed on 5/27/09) and Exhibit 93-J (Settlement and Release Agreement Addendum No. 1 Between Reserve Casualty Corp. and Peak Mechanical and Components, Inc. executed on 1/30/12).

[79] *See Reserve* at page 41.

[80] *See* Note 30 supra regarding insurance industry pooling arrangements that rebuke the Court's criticisms.

[81] *See* Consolidated Appropriations Act of 2015 (also known as the Protecting Americans From Tax Hikes Act (the "PATH" Act) of 2015), which was effective for tax years beginning after December 31, 2016. The PATH Act added a new "diversification requirement" that basically eliminates an estate planning benefit from a captive operating under IRC §831(b) but not otherwise. This diversification requirement can be met by a captive satisfying one of two alternative tests. The second test for satisfying this diversification requirement essentially requires ownership of the insurer to mirror ownership of the insurance company. The PATH Act also increased from $1.2 million to now $2.3 million the cap on

premiums for an insurer operating under Code Section 831(b). So, while this Court is concluding that affiliated insurance arrangements are unacceptable on a wide variety of grounds (essentially an alleged circuitous flow of funds), Congress was almost doubling the caps on the tax provision. Section 821(b)((2)(A)(i).

[82] 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 enabling a taxpayer to qualify for tax benefits as a result of satisfying the precise requirements of the relevant section 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 – a "domestic international sales corporation" (DISC) – to transfer money from their family-owned company to their sons' Roth Individual Retirement Accounts (IRAs). In the related case of *Benenson v. Commissioner*, 887 F.3d 511 (1st Cir. 2018), the First Circuit explained as follows when the IRS attempted to the apply the substance over form doctrine to the taxpayers in *Summa*: "**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**… In sum, we agree with the Sixth Circuit that Congress created DISCs "to enable exporters to defer corporate income tax." "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**." (Emphasis added).

[83] Dr. Neil Doherty's expert testimony at trial (referencing his expert report) explained this industry standard concept of "layering risk":

> "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 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***. In this way, PoolRe assumes a portfolio of all the higher layer losses of the member companies. PoolRe then fully reinsures this pool back to all of the captives on a proportional (quota share) basis. Put together these two arrangements (the direct insurance and the reinsurance) result in each captive:
>
> 1. fully insuring the lower layer of losses of its own affiliate(s); and
>
> 2. reinsuring a small percentage of the pooled higher layer losses of all the members.

Given that there are more than 50 insurance companies participating in the Capstone program in 2008/9/10, then virtually all the exposure assumed by any captive under the quota share reinsurance is entirely unrelated to the captive's affiliate." (Emphasis added).

See testimony of Dr. Neil Doherty, Tr. at 235-236 and Exhibit 104-P (Expert Report of Dr. Neil Doherty, March 27, 2017), pages 14-15.

[84] *See* testimony of Robert Snyder, Tr. at 35-37. Mr. Snyder testified that "A quota share reinsurance policy is a policy that would typically be used by a reinsurance pool where a portion of the risks that are underwritten by other insurance companies – in this case it would be captive insurance companies – that ceded to the quota share reinsurer proportionately, and the reinsurer then basically will cede back to the captive insurance company a small portion for that pool of risk."

[85] *See* Opinion at page 40, where the Court stated that "Respondent contends that the quota share arrangement provided the appearance of risk distribution without actually distributing any risk." *See also* Opinion at page 47, where the Court concluded that "The purported reinsurance agreements between [PoolRe] and Reserve did not allow Reserve to effectively distribute risk." The Court did not and could not cite to any evidence to support this conclusion, since the government offered no testimony or evidence to controvert the testimony of Reserve's multiple witnesses regarding the purpose of PoolRe's quota share arrangement and its effectiveness in achieving risk distribution on behalf of Reserve.

[86] Oliver Schofield, "*Reserve Mechanical: Judge Kerrigan Shows 'Limited Knowledge' of Reinsurance Market*," June 28, 2018. Mr. Schofield's article can be viewed here. In this article, published by Captive Review, London reinsurance expert, Oliver Schofield, managing partner at risk and insurance consultancy RISCS, questions whether Judge Kerrigan fully understands the use and purpose of quota share contracts and explains that the stop loss "attachment point" in the PoolRe pooling arrangement was appropriate since the purpose of stop loss coverage is to serve as "protection against a catastrophic deterioration in loss frequency and as such should attach beyond the 1 in 10 year expected loss scenario." Mr. Schofield further explains that it is advisable for a captive to only retain a "distant aggregate excess of loss layer" to avoid "being taken to the 'mortuary chapel' by risks over which it has zero control or influence."

[87] *See* Pat Magarick & Ken Brownlee, "*Captives and underwriting pools*," Casualty Insurance Claims, 4th Ed., § 46:8 (November 2018 update). This treatise describes the importance of captive reinsurance as follows: "One aspect of captive insurance is that of reinsurance. What makes the use of a captive attractive to corporate owners is that the capacity of the captive can be expanded through reinsurance, which adds both protection for high losses on whatever basis negotiated and also adds to surplus….. In the 21st century, reinsurance for captives is both readily available and inexpensive, and reinsurers pursue such business."

See also Michael R. Mead, "*Captive 'Reinsurance' Causes Confusion*," National Underwriter, P&C Ed., April18, 2005, Page 32. Mr. Mead explains the important role that reinsurance plays for captives as follows: "Reinsurance and excess insurance can be structured to protect a captive from a single loss above its capacity, or from an aggregation of many losses in a policy period. These are often called vertical and horizontal losses, or specific and aggregate. A typical structure would occur when the "front" accepts little or no risk, placing up to 100 percent of the exposure with others. The captive can then arrange reinsurance behind its limits or obtain excess coverage over and around its limits." As Mr. Mead further explains, "Regulators might question the captive's ability to accept responsibility for the limits if the reinsurer fails, as all exposure is on the captive's books. For this reason, reinsurance of the captive is usually done as excess of the captive's retention. This may reduce some costs, capital requirements and regulatory concerns. An excess insurance policy can be written to not respond until the loss reaches beyond the attachment point of the captive – known as straight excess. Attachment points and actuarial projections become critical to the captive's acceptability and probability of success."

[88] *See* H. Wayne, Editor Snider. *Readings in Property and Casualty Insurance* (1959), Chapter 19 by Otis Clark (Principles of Company Underwriting and the Mechanics of Reinsurance). In this chapter, Mr. Clark explains a "stop loss" or "excess of loss ratio" reinsurance pool as follows: "Stop loss or excess of loss ratio covers are well named for they accomplish just that purpose; that is, by the use of such covers a company is able to determine a given loss ratio it is willing to sustain on a given classification of business. One of the most common usages of this form applies to hail insurance. The mechanics of this type of cover usually works out something like this – a company wants to stop its earned premium loss ratio on its hail writings at 60 per cent, which means that as soon as its experience has hit this factor its stop loss cover steps in to provide the balance of cover up to certain prescribed limits. Many of these forms of contracts require the originating company to stand for its own account at least a small percentage of the amounts involved over and above the prearranged loss ratio limit. In other words, these covers are so flexible in design that they can be arranged to fit any imaginable set of conditions. Hail insurance is only one type of risk protected against such losses. In fact, these covers apply equally well on any class of business exposed to catastrophic losses." (Emphasis added).

[89] *See Reserve* at page 41.

[90] Actuaries testifying or providing support for Reserve's policy pricing included: **(1) Esperanza Mead** (testifying that Reserve's policy pricing was reasonable), see Tr. at 407-436 and Exhibit 113-P (Expert Actuarial Peer Review Report of Esperanza Mead, March 10, 2017), **(2) Michael Solomon**, testifying that Reserve's policy pricing was reasonable, see Tr. at 466-494, and Exhibit 117-P (Expert Actuarial Review Report of Michael Solomon March 27, 2017). **(3) Gary Fagg** (testifying that he was closely involved with negotiating and administering PoolRe's coinsurance arrangement with a publicly held insurer for multiple years, see Tr. at 442-447 and Exhibit 52-J (Credit Insurance Coinsurance Contract Issued to PoolRe Insurance Corp. by Reserve CC effective November 26, 2008), and **(4) Stephen Glicksman** (providing advice about the "appropriate split" of premiums that were allocated between Reserve and PoolRe for Reserve's direct written coverages. *See also* testimony of Lance McNeel, CPCU at Tr. at 369-372.

[91] *See* testimony of Lance McNeel, Tr. at 341-342, and Exhibit 109-P (Pricing Indications, for policy periods ending 12/31/08, 12/31/09/ and 12/31/10, prepared for Reserve Casualty Corporation by Mid-Continent General Agency, Inc., Underwriters at Lloyds of London).

[92] *See* testimony of Lance McNeel, Tr. at 341-342, and Exhibit 109-P (Pricing Indications (for policy periods ending 12/31/08, 12/31/09/ and 12/31/10) prepared for Reserve Casualty Corporation by Mid-Continent General Agency, Inc., Underwriters at Lloyds of London)).

[93] *See* Exhibit 95-J (Letter from actuary Steven Glicksman to Capstone's Lance McNeel, CPCU, January 31, 2012 with "Discussion of PoolRe's Coverage Options"), referencing a previous letter from Mr. Glicksman to Mr. McNeel dated October 20, 2009. *See also* testimony of Lance McNeel, Tr. at 369-372, where Mr. McNeel testified that Mr. Glicksman is the actuary who provided Capstone advice about the "appropriate split" of premiums that were allocated between Reserve and PoolRe with respect to the direct written policies that were jointly underwritten by Reserve and PoolRe. Mr. McNeel further testified that Exhibit 96-J was used by Capstone to set the "appropriate split."

[94] *See* presentation by Guy Carpenter Company at 2017 CAJPA Annual Conference, "*Pools and the Reinsurance Market, What you need to know*," September 13, 2017, Slide 24. This presentation can be viewed here. Guy Carpenter is a risk and reinsurance intermediary of Marsh & McLennan Companies, Inc., the world's largest insurance brokerage firm.

[95] *Id*. at Slide 26.

[96] *See Reserve* at page 61.

[97] *See Reserve* at page 61.

[98] *See* Note 111 infra.

[99] *See* testimony of Lance McNeel, Tr. at 341-359.

[100] *See* testimony of Lance McNeel, Tr. at 323-361.

[101] *Id*.

[102] *See* testimony of Lance McNeel, Tr. at 356-366. Mr. McNeel testified that the premium pricing for each type of coverage that was underwritten by Reserve for the coverages provided to the Peak insureds, as reflected on Exhibit 112-P (Reserve Casualty Corp. - Rating Worksheet for Peak Mechanical, Inc. for policy years 2008, 2009, and 2010), took into account multiple individual factors, including Reserve's premium indications (received from Mid-Continent General Agency, Inc.), 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 taking into account all of these factors.

[103] *Id*.

[104] *See* Reserve at pages 42-43.

[105] *See* testimony of Dr. Neil Doherty, Tr. at pages 235-236 and Exhibit 104-P (Expert Report of Dr. Neil Doherty, March 27, 2017), pages 14-15, where Dr. Doherty stated 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**." (Emphasis added).

[106] *See* Exhibit 96-J (Letter from Myron Steves Insurance Solutions to PoolRe Insurance Corp., May 31, 2005, signed by Robert L. Snyder, Director, Risk Consulting) where Mr. Snyder stated: "The stop loss structure is one alternative, a reasonable one, in our view, to limiting the liability of the 'primary' insurer, and assuring the insured of a source of funds to pay losses which may be in excess of the amounts the primary insurer desires to retain. **Other structures common to the insurance industry can be utilized to achieve a similar result**, such as the purchase of primary insurance from one insurer, and direct excess (or "'umbrella" insurance) provided from another insurer on the same coverage terms as the primary." (Emphasis added).

[107] *See* Exhibit 95-J (Letter from actuary Steven Glicksman to Capstone's Lance McNeel, CPCU, January 31, 2012 with "Discussion of PoolRe's Coverage Options"), referencing a previous letter from Mr. Glicksman to Mr. McNeel dated October 20, 2009. *See* pages 2-3 and "Exhibit -1" to Exhibit 95-J, which reflected the factors considered by actuary Glicksman in calculating the percentage of direct written premiums to be paid to PoolRe by each participating captive. *See also* Exhibit 96-J (Letter from Myron

Steves Insurance Solutions to PoolRe Insurance Corp., May 31, 2005, executed by Robert L. Snyder, Director, Risk Consulting). In this letter, Mr. Snyder stated as follows regarding the PoolRe pooling arrangement: "The stop loss program…is one of several acceptable approaches to limiting the risk retained by a particular insurer. In the PoolRe model, clearly most of the risk is retained by the captive insurer in the first instance, with the stop loss coverage applying upon the happening of various triggering events. The 81.5%/18.5% premium allocation is reasonable within this context, recognizing that in our judgment stop loss coverage in general might fairly be priced at anywhere from 2.5% to 30% of written premium."

[108] *See* testimony of Lance McNeel, Tr. at 356-366. *See also* Note 111 infra.

[109] *See* Exhibit 95-J (Letter from actuary Steven Glicksman to Capstone's Lance McNeel, CPCU, January 31, 2012 with "Discussion of PoolRe's Coverage Options"), referencing a previous letter from Mr. Glicksman to Mr. McNeel dated October 20, 2009. *See* pages 2-3 and "Exhibit -1" to Exhibit 95-J for factors considered by actuary Glicksman in calculating the percentage of direct written premiums to be paid to PoolRe by each participating captive.

[110] *Id*.

[111] *See* testimony of Lance McNeel, Tr. at 323-366 on the pricing procedures implemented for all captives (including Reserve) administered by Capstone. Mr. McNeel testified at page 356 regarding Capstone's procedures in obtaining individual pricing indications that are unique to each of its administered captives. *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 Casualty Corp.), 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, 2009, and 2010). Mr. McNeel testified that the premium pricing for each type of coverage that was underwritten by Reserve for coverages provided to Peak Mechanical, as reflected on Exhibit 112-P, took into account multiple individual factors, including Reserve's premium indications (received from Mid-Continent General Agency, Inc.), 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 taking into account all of these factors. *See* Tr. at 356-366.

[112] *See* Exhibit 16-J (Captive Insurance Company Feasibility Study for Peak Mechanical & Components, Inc., Initial Site Visit: August 13, 2008) and testimony of Lance McNeel, Tr. at 313-322.

[113] *See Reserve* at page 61.

[114] *See* Exhibit 95-J and Exhibit 96-J and Note 107 infra, discussing the guidance provided to PoolRe both by (a) actuary Stephan Glicksman and (b) Myron Steves Insurance Solutions.

[115] *See Reserve* at page 44.

[116] *See* testimony of Lance McNeel, Tr. at 356. Mr. McNeel testified that, for both Reserve and each other captive insurance company that was managed by Capstone, "it was [his] practice to get a pricing indication from a company like Mid-Continent" that was unique to each such captive."

[117] At *Reserve* at page 57, **the Court erroneously concluded that a past loss history must be shown by Reserve** before it would have the ability to underwrite insurance policies to insure the Peak insureds, 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 [could be purchased in the marketplace]. 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**." (Emphasis added).

[118] *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).

[119] *See Reserve* at pages 44-45.

[120] *See* Note 68 supra. Two different witnesses testified to the fact that PoolRe was an insurance company licensed by a territory of the United Kingdom during all years at issue, and their testimony was unchallenged.

[121] *See Reserve* at page 45.

[122] *See* Exhibit 132-P (39 Separate Ruling Determinations Issued by the IRS to Property and Casualty Insurance Companies Managed by Capstone in Recognition of Exemption from Federal Income Tax Under section 501(c)(15) of the Internal Revenue Code). *See also* testimony of Stewart Feldman, Tr. at 676. Mr. Feldman testified that Exhibit 132-P contained 39 different ruling determinations, affirmative rulings from the Internal Revenue Service, which were "approvals from the Service on a 501(c)(15) determination, based on a Form 1024 application." Mr. Feldman also testified that the captive insurance companies that were the subject of these 39 ruling requests were "basically exactly the same" (referring to the fact that each of these captives had participated in the same PoolRe pooling arrangement in which Reserve had participated). *See* Tr. at 676.

[123] *See* Exhibit 136-R (Opening Expert Report of Donald J. Riggin, March 27, 2017), page 10, paragraph 30.

[124] *See* Exhibit 136-R (Opening Expert Report of Donald J. Riggin, March 27, 2017), page 10, paragraph 31.

[125] *See* Exhibit 136-R (Opening Expert Report of Donald J. Riggin, March 27, 2017), page 15, paragraph 55.

[126] *See* Exhibit 137-R (Rebuttal Expert Report of Donald J. Riggin, April 10, 2017), pages 4-5, paragraphs 5-12.

[127] *See* Exhibit 137-R (Rebuttal Expert Report of Donald J. Riggin, April 10, 2017), page 5, paragraphs 12.

[128] *See* Exhibit 137-R (Rebuttal Expert Report of Donald J. Riggin, April 10, 2017), page 4, paragraph 7. Mr. Riggin's position on "homogeneity of exposure units" was not consistent with (and more restrictive than) the position taken by the IRS with respect to this issue. Although Mr. Riggin argued that homogeneity is an absolute requirement, the IRS has never done so. The IRS requested comments in Notice 2005-49 concerning the relevance of homogeneity in determining whether risks are adequately distributed for an arrangement to qualify as insurance. However, the IRS has not published any guidance stating that homogeneity is required. The IRS Office of Chief Counsel made the following statements regarding homogeneity in CCA 200849013 (Dec. 5, 2008): "We have mentioned homogeneity in several revenue rulings without addressing the relevance of homogeneity as a factor in the subsequent insurance analysis… We have not yet published guidance expressing our position on this issue."

[129] *See* Exhibit 107-P (Dr. Neil Doherty – Rebuttal of Expert Report of Mr. Donald J. Riggin, April 5, 2017), page 5, where Dr. Doherty explained that homogeneity of exposure units is not a requirement for an insurer to be able to estimate expected losses: "**Mr. Riggin's statement that homogeneous exposures are necessary in order to estimate expected losses is patently false**. As I described above, we have standard actuarial techniques to estimate average losses in portfolios with heterogeneous risks. Moreover, the most basic part of the actuary's toolbox is the technology for insurance risk classification, i.e., estimating the expected losses in portfolios of different risks. In insurance classification, one estimates the extent to which different features of the exposures (e.g., in auto insurance we look at differences in age, gender, type of car, years of accident free driving, etc.) contribute to differences in expected losses. This is done usually by a set of standard statistical techniques know as multivariate analysis." (Emphasis added).

[130] *See Reserve* at pages 51-52.

[131] *See Reserve* at page 53.

[132] *See* testimony of Stewart Feldman, Tr. at 615. In describing the business of Capstone, Mr. Feldman testified that the second of two "lines of business" that Capstone is involved in is "administering alternative risk funding programs or alternative risk transfer programs or... administering captive insurance arrangements." *See also* Tr. at 636-637, where Mr. Feldman testified that Capstone's "insurance department "handles the binding of policies, the preparation of [the declaration pages in the policies, on-site feasibility studies from the insurance side. The [Feldman law firm] also joins in on that, coordinating with the outside actuaries, underwriters, consultants, [and] risk managers and [provides services to assist in handling] claims payment, claims handling, claims adjusting, designing coverages with the lawyers, and providing input, of course, to the accounting department on reserves that need to be booked for the captive." *See also* Tr. at 637, where Mr. Feldman testified that Capstone is also responsible for providing services with regard to "premium pricing" for captives, which was handled by Mr. McNeel for the three years at issue in *Reserve* (2008 – 2010). Mr. Feldman further testified that Mr. McNeel "worked with a team of actuaries and underwriters and lots of people providing input to him" and, in referencing the services provided to a captive by Capstone, Mr. Feldman testified that "**[U]ltimately it's the client's decision. We're not – it's not our company. We're the advisors**." (Emphasis added). As this testimony makes clear, Capstone does not have the authority to make any decisions on behalf of a captive and only acted in its capacity as an advisor to Reserve's management and board of directors.

[133] The Court's criticism of the relationship between Reserve and Capstone disregarded testimony of Reserve's owner that he relied on Capstone and his professional team to advise him on decisions relating to Reserve's operational matters. *See* testimony of Norman Zumbaum, Tr. at 135-138 and testimony of Norman Zumbaum on cross-examination, Tr. at 165-167. On cross-examination, Mr. Zumbaum testified that he "scanned through" 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 Mr. McNeel, Mr. Feldman or other 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 by his advisors at Capstone.

[134] For example, an employer that sponsors a qualified retirement plan chooses to hire professionals to navigate the employer, as the client, through an array of very complex retirement plan rules. The client hires retirement specialists to focus on ensuring that the retirement plan is designed properly, operated in compliance with complex tax and ERISA laws, and maintains in compliance with fiduciary responsibilities. In a similar manner, a client hires a captive manager to navigate the client through an array of complex rules in operating an insurance company, including advising on coverage design, policy selection and drafting, premium pricing, and claims handling, and to coordinate state insurance regulatory (compliance and reporting) matters, along with advising on risk mitigation (e.g., pooling and reinsurance) transactions.

[135] *See* Exhibit 97-P (Expert Report of Bob Snyder, March 27, 2017), page 2.

[136] *See* Exhibit 103-P (Expert Report of Steve Kinion, March 26, 2017), pages 7-11.

[137] *See* Exhibit 130-P (Expert Report of David B. Liptz, CPA, March 23, 2017, page 2.

[138] *See Reserve* at page 52, where the Court stated that "Peak did not submit and Reserve did not insist on obtaining any documents to substantiate the occurrence or the amount of the claimed loss."

[139] *See* Exhibit 89-J (check for claim payment to Peak Mechanical and Components, Inc. in amount of $150,000 on 4/21/09), Exhibit 91-J (check for claim payment to Peak Mechanical and Components, Inc. in amount of $14,980 on 5/27/09), and Exhibit 92-J (check for claim payment to Peak Mechanical and Components, Inc. in amount of $175,000 on 9/10/09. *See also* Exhibit 90-J (Settlement and Release Agreement Between Reserve Casualty Corp. and Peak Mechanical and Components, Inc. executed on 5/27/09) and Exhibit 93-J (Settlement and Release Agreement Addendum No. 1 Between Reserve Casualty Corp. and Peak Mechanical and Components, Inc. executed on 1/30/12).

[140] *See* testimony of Lance McNeel, Tr. at 387-388. Mr. McNeel testified that, in his capacity working with Capstone, he worked with policies that were common to a lot of different clients and that he would talk about these types of common policies with many clients who might be interested in setting up a captive insurance company. Mr. McNeel also testified that Capstone had many policies that were manuscripted specifically for a particular client in certain situations. *See also* testimony of Stewart Feldman, Tr. at 763-764. Mr. Feldman testified that Capstone drafted "manuscripted policies" in many situations, which meant to him that such a policy is a custom or semi-custom policy directed at a particular business.

[141] *See Reserve* at page 61.

[142] At *Reserve* at 59-60, the Court stated as follows "Generally, we conclude that premiums are reasonable when it can be shown that the amounts agreed upon by the parties were the result of arm's-length negotiations. *See R.V.I. Guar. Co. & Subs. v. Commissioner*, 145 T.C. at 231-232; *Harper Grp. v. Commissioner*, 96 T.C. at 60. In determining whether an arrangement constitutes insurance in the commonly accepted sense we consider more than whether the premiums chosen can be arrived at by actuarial means. We consider whether the facts demonstrate that the terms of the arrangement were driven by arm's-length considerations. *See R.V.I. Guar. Co. & Subs. v. Commissioner*, 145 T.C. at 234-235 (finding the subject policies constituted insurance in the commonly accepted sense because the policies' terms "correspond to, and are driven by, the characteristics and business needs of the underlying * * * transactions")."

[143] *See* Note 81 supra. Congress clearly envisioned that the insureds and the insurer would be related parties in the vast majority of situations of an insurance company operating under IRC §831(b), as reflected by recent amendments to IRC §831(b) under the Consolidated Appropriations Act of 2015, also known more commonly as the Protecting Americans From Tax Hikes Act (the "PATH" Act) of 2015.

[144] 96 T.C. 45 (1991), aff'd, 979 F.2d. 1341 (9th Cir. 1992).

[145] *See Harper* at 50.

[146] *Id*. (emphasis added).

[147] *Id*. (emphasis added).

[148] *Id*. at 60.

[149] *See* Exhibit 107-P, Rebuttal Expert Report of Dr. Neil Doherty (Rebuttal of Expert Report of Mr. Donald J. Riggin, April 5, 2017), pages 5-7. In his rebuttal expert report to Mr. Riggin's expert report, Dr. Doherty refuted Mr. Riggin's claim that a lack of loss history was necessary for Reserve to be able to determine premiums. Dr. Doherty explained 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." Dr. Doherty concluded that Reserve's process in setting premiums "seems quite sensible."

[150] *See* Exhibit 147-P, Rebuttal Expert Report of Michael Solomon (Rebuttal to Expert Report of Mr. Donald J. Riggin, April 9, 2017), page 2. Mr. Solomon stated as follows in his rebuttal report: "Actuaries do not require a relatively large pool of homogeneous loss exposures to project expected losses. Actuaries are constantly engaged to project expected losses without large amounts of data… In my experience as an actuary I have often been asked to project expected losses for new insurance products, in the absence of data. For instance, I have been asked to project expected losses for tire and rim insurance, and mechanical breakdown insurance, on new vehicles. I have also been asked to price the cost of new products, such as AutoNation's Vehicle Protection Plan, or Porsche's Pre-Paid Maintenance program."

[151] *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, Tr. at 466-494, and Exhibit 117-P (Expert Actuarial Review Report of Michael Solomon, March 27, 2017).

[152] *See* Exhibit 94-J (Letter from Lawrence M. Keefe, Senior Vice President of Mid-Continent General Agency, Inc. to Lance McNeel, "Premium Rating Methodology for Captives," April 28, 2009). In this letter, Mr. Keefe stated as follows: "The process we have utilized on Capstone's behalf involves the evaluation of exposures for a given line of insurance, examination of historic loss date, if any, the consideration of the increased limits factors that might be reasonably applicable, and acknowledgment of market rate adjustments that might impact the commercial market's pricing of risk on a cyclical basis. From our experience working with many types of risk and with numerous insurers, we can apply our judgment to factors of this nature, in order to provide what we think are reasonably credible pricing indications to Capstone." *See also* Tr. at 323-324, where Mr. McNeel testified that Exhibit 94-J accurately describes "how the premiums that are reflected in Reserve Casualty Corporation's insurance policies were determined" for 2008, 2009, and 2010.

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 Casualty Corp. for policy years 2008, 2009, and 2010).

See also testimony of S. Lance McNeel, Tr. at 356-366. Mr. McNeel testified that the premium pricing for each type of coverage that was underwritten by Reserve for coverages provided to Peak Mechanical, as reflected on Exhibit 112-P (Reserve Casualty Corp. - Rating Worksheet for Peak Mechanical, Inc. for policy years 2008, 2009, and 2010), took into account multiple individual factors, including Reserve's premium indications (received from Mid-Continent General Agency, Inc.), 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 these factors.

[153] *See* Exhibit 113-P (Expert Actuarial Peer Review Report of Esperanza Mead, March 10, 2017) and Exhibit 117-P (Expert Actuarial Review Report of Michael Solomon, March 27, 2017).

[154] Anne Marie Towle, captive practice manager at JLT Insurance Management, released the following statement following the verdict in *Reserve*: "It would seem that this tax court case bears no resemblance to the *Avrahami* case, as Reserve Mechanical cites numerous reasons and transactions showing how its business was insurance-related." Ryan Work, vice president of government relations at the Self-Insurance Institute of America (SIIA), said he was also concerned about the Court's improper reliance on *Avrahami*, stating as follows: "Simply, looking at *Reserve* and *Avrahami*, they're very different captives in different areas of the country, looking at different risks." "You can't compare terrorism cover in the greater Phoenix area to a captive covering various mining risks in Nevada." "I was surprised that there were so many references to *Avrahami*, it is fresh in the court's mind, and I understand that, but there is also a number of case law and precedent before that, which was wholly set aside."