

Tax Court Confused Over Insurance Industry, Co. Tells 10th Circuit

By **David Hansen**

Law360 (February 24, 2020, 9:06 PM EST) -- The U.S. Tax Court misunderstood the nature of the insurance industry when it ruled erroneously that a captive insurer of an Idaho hazardous mining company didn't qualify for a tax deduction, the insurance company has told the Tenth Circuit.

The mining company, Peak Mechanical & Components, formed its own insurer, Reserve Mechanical Corp., which should have received a tax deduction Congress created for captive insurers because it spread the risk of operations among several parties and operated like a traditional insurance company, Reserve said in a brief filed Friday.

The case is groundbreaking because it is the first to consider how a captive insurance company distributes risk through a pool of other insurers, Reserve said.

"Instructive case law in this area from other jurisdictions is very limited, so this court's decision is likely to have a major impact on the insurance industry as a whole," Reserve said.

Peak Mechanical could not find a firm specialized enough to indemnify its business of making, selling and cleaning heavy machinery used in underground mining, so it formed one, Reserve said. Congress recognized the need to make such independent firms viable by offering them a tax exemption under Internal Revenue Code [Section 501\(c\)\(15\)](#), attorneys for Reserve said. The U.S. Tax Court refused to recognize Reserve's exempt status, believing the company did not spread risks among policyholders or act like a traditional insurance company, the company said.

Because the company was not an insurance company, it did not qualify for an exemption for its income and it was subject to a 30% withholding tax on U.S.-source income, the court said in a 2018 decision. But Reserve partnered with a pool of at least 50 other insurers, it said. If one partner incurred a loss, the others were contractually obliged to pay on the claim, it said.

The Tax Court also claimed that Peak did not have "a genuine need" for pollution liability insurance because it operated for 10 years without incurring a liability. "This flawed reasoning is akin to saying that automobile insurance is unnecessary for drivers who have not yet had an accident," Reserve said.

Legal representatives of Reserve and the commissioner did not respond to requests for comment. Reserve Mechanical is represented by Val J. Albright and Michelle Y. Ku of Foley & Lardner LLP and by E. John Gorman, Logan R. Gremillion and Coby M. Hyman of the Feldman Law Firm LLP.

The IRS is represented by Geoffrey Klimas of the U.S. Department of Justice, Tax Division.

The case is Reserve Mechanical Corp. v. Commissioner of Internal Revenue, case number 18-9011, in the U.S. Court of Appeals for the Tenth Circuit.

--Additional reporting by Eric Kroh. Editing by John Oudens.