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IRS Microcaptive Victory Hinged on Faulty Analysis, Company Says

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By Emily L. Foster

A microcaptive insurer argues that the Tax Court's "fundamentally flawed" assessments led to an erroneous conclusion that the company's transactions weren't insurance for federal tax purposes.

Reserve Mechanical Corp.'s appeal challenges the Tax Court's ruling that the microcaptive's arrangements failed to satisfy two of four case law criteria — risk distribution and whether the captive is operating the way a normal insurance company would — for determining whether an arrangement constitutes insurance eligible for tax benefits.

In its February 21 opening brief, Reserve asks the Tenth Circuit to carefully consider and examine "complex and esoteric tax and insurance law matters" in what will be the first circuit court decision to analyze a "captive insurer's risk distribution through reinsurance arrangements and participation in a risk pool."

In June 2018 the Tax Court (T.C. Memo. 2018-86) granted the IRS its second major victory against a microcaptive insurance company, finding that Reserve failed to operate as a bona fide insurance company and that the policies it issued lacked a legitimate business purpose.

Judge Kathleen Kerrigan, relying heavily on the analysis in the court's seminal microcaptive case — *Avrahami v. Commissioner*, 149 T.C. 144 (2017) — concluded that Reserve's arrangements didn't constitute insurance contracts for federal income tax purposes, and therefore the captive doesn't qualify as a tax-exempt insurance company under section 501(c)(15) and is ineligible to elect to be treated as a domestic corporation under section 953(d).

Despite three Tax Court cases, it remains unsettled what constitutes a valid microcaptive insurance arrangement.

The hope is that the Tenth Circuit at least provides guidance on some issues Reserve raises, particularly risk distribution, because most captive arrangements involve a risk-pooling mechanism, Rachel L. Partain of Caplin & Drysdale Chtd. told *Tax Notes*.

A circuit court decision could help taxpayers considering whether to settle with the IRS or continue litigation as the IRS ramps up its enforcement, Partain said.

Reserve made good arguments attacking *Avrahami*, according to Partain. She said that's important because the Tax Court continues to apply its risk distribution approach and reasoning in that case to others "with nothing more than just a citation."

No Sham Analysis

Reserve pointed out in its brief that courts generally conduct “a threshold inquiry to determine whether the captive insurer is a sham” before proceeding with the four-part analysis of whether the captive’s transactions constituted insurance.

The Tax Court, however, didn’t answer that gating question — “whether Reserve was created for a legitimate purpose or was in fact a sham,” but rather conducted that analysis later of the wrong entity, PoolRe Insurance Corp., the company said.

According to Partain, practitioners are concerned that the Tax Court has woven the sham transaction analysis “throughout the application of the insurance doctrines, which then potentially twisted” those assessments, rather than addressing the issue up front.

The Arrangements

Peak Mechanical & Components Inc., which manufactures and services underground mining machinery, sought specialized insurance to cover pollution and other risks. Based on a feasibility study and recommendation by Capstone Associated Services, Peak formed Reserve — its own captive insurance company.

Reserve was organized and regulated as an insurance company in Anguilla and satisfied that jurisdiction’s regulatory requirements. During the tax years in question, Reserve issued between 11 and 13 direct-written policies annually that insured Peak and two affiliates against those risks.

The three direct insureds paid about 80 percent of the premiums to Reserve with the remainder going to PoolRe, an unrelated insurer.

PoolRe and Reserve jointly underwrote stop loss coverage policies, which reimburse a portion of losses exceeding a predetermined amount. PoolRe also managed a reinsurance risk pool commonly used in the industry to distribute or spread risks, in which insurers or reinsurers accept fixed percentages of all business underwritten.

PoolRe ceded out all the risks under the stop loss endorsements, “thereby reinsuring the pooled risks with all of the pool participants on a proportional (quota share) basis, and those participants agreed to pay their respective proportionate share of the PoolRe losses.”

Reserve, along with more than 50 other captive insurers that Capstone administered, participated in the risk pool.

With the pooling arrangement, each captive wasn’t insuring only affiliated insureds but rather was distributing its overall risk among hundreds of unrelated policyholders, Reserve argued.

Reserve also reinsured under a coinsurance contract unrelated risks involving a large pool of vehicle service contracts that PoolRe had reinsured under a contract with Credit Reassurance Corp. Ltd., an unrelated company.

Thus, Reserve effectively distributed risk because more than 30 percent of its gross premiums were derived from insurance unrelated to the captive insurance arrangement with its direct insureds, the company argued, citing *Harper Group v. Commissioner*, 96 T.C. 45 (1991).

But the Tax Court, citing *Avrahami*, said, "Before we can determine whether Reserve effectively distributed risk through these agreements, we must determine whether PoolRe was a bona fide insurance company."

That's where the Tax Court went awry, according to Reserve.

Defective Distribution Analysis

"Relying on *Avrahami* . . . the court misapplied the legal test for risk distribution by focusing on PoolRe, instead of Reserve, and requiring PoolRe be a bona fide insurance company for Reserve to be able to distribute risk through its arrangements with PoolRe," Reserve argued.

Further, having a bona fide insurance company isn't required for risk distribution to exist, Reserve said, adding that "well-established case law [recognizes] insurance for federal tax purposes even where no insurance company exists."

Reserve emphasized that courts evaluating risk distribution look at the insurer's actions — not those of the insured — "because it is the insurer's risk that is reduced by risk distribution." That means the risk distribution is analyzed "from the insurer's perspective and by looking solely to the pool of risks assumed by the insurer."

But rather than apply those precedents, the Tax Court proceeded with the four-part test for a bona fide insurance company and concluded that PoolRe didn't qualify and therefore Reserve's reinsurance arrangements with PoolRe weren't insurance for tax purposes.

"Before *Avrahami*, no court had held that a captive insurer can achieve risk distribution by reinsuring an unrelated party *only if* the unrelated party itself is a bona fide insurance company," Reserve said.

Policy Misconstrued

According to Reserve, the Tax Court erroneously held that the company's transactions weren't "insurance in the commonly accepted sense."

In concluding that Reserve charged unreasonable premiums and wasn't operated like an insurance company, the Tax Court "relied on a patently incorrect reading of Reserve's direct-written policies, as providing only excess coverage," the brief said.

"By misinterpreting and mischaracterizing Reserve's policies as excess insurance, the tax court inevitably found that (1) Reserve's premiums were unreasonable and not negotiated at arm's length, (2) there was no 'real business purpose' for Reserve's policies, and (3) Peak lacked 'a genuine need for acquiring additional insurance.'"

Income or Capital

The Tax Court also concluded that the payments Reserve received — excluding the gross premiums for the coinsurance contracts — are subject to the 30 percent withholding tax under section 881(a), having found the company not to be an insurance company and ineligible to make the section 953(d) election to be treated as a domestic corporation.

Reserve argues that if the Tax Court correctly determined that the payments it received from its affiliated insureds weren't for insurance because there was no legitimate purpose, the amounts should be treated as nontaxable capital contributions rather than taxable income.

"Because the funds in this situation are found in the sister corporation (i.e., Reserve), there is a deemed contribution of the funds from the common parent . . . to the sister corporation," Reserve said, citing Rev. Rul. 78-83, 1978-1 C.B. 79.

"The only potentially applicable characterization is a contribution to capital," Reserve asserted.

The petitioners in *Reserve Mechanical Corp. v. Commissioner*, No. 18-9011 (10th Cir. 2020),

are represented by attorneys from Foley & Lardner LLP and the Feldman Law Firm LLP.