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Another Micro-Captive-Case Loss: 10th Circuit Affirms Tax Court Ruling in *Reserve Mechanical Corp. v. Commissioner*

On May 13, 2022, in *Reserve Mechanical Corporation v. Commissioner*,[1] the U.S. Court of Appeals for the Tenth Circuit affirmed a Tax Court decision that a micro-captive insurance company did not qualify for the exemption from income tax as a small insurance company under I.R.C. § 501(c)(15). Therefore, the purported premium payments the company received constituted fixed, determinable, annual, or periodical (FDAP) income taxable at a rate of 30% under I.R.C. § 881(a). The IRS scrutinizes micro-captive transactions because of their potential for tax evasion. For purposes of the disclosure requirements, the IRS has identified certain micro-captive transactions as "listed transactions" in Notice 2016-66. A court recently invalidated Notice 2016-66 for failing to comply with the Administrative Procedure Act;[2] however, *Reserve Mechanical* illustrates that micro-captive transactions remain vulnerable on the merits.

The Facts

In *Reserve Mechanical*, two shareholders owned and operated a mining company, Peak Mechanical Corp. (Peak). Prior to the years at issue, Peak had commercial insurance coverage and paid annual premiums of

[1] 129 AFTR 2d 2022-1804 (10th Cir. 2022).
[2] *CIC Services, LLC v. IRS*, Case No. 3:17-cv-110 (E.D. Tenn. Mar. 21, 2022). *See* GT Alert, Court Invalidates Notice 2016-66 on Micro-Captive Transactions, the Second Time an IRS Notice Was Vacated This Month.

$100,000. In 2008, the two shareholders consulted with Capstone Associated Services, Ltd. (Capstone) about establishing a micro-captive insurance company. Capstone promised to provide the shareholders with a feasibility study; however, the shareholders proceeded to establish Reserve Mechanical Corp. (Reserve) in the British West Indies prior to reviewing that information. Reserve did not have employees. Capstone provided management services to Reserve, including preparing the policies and determining the premiums. One of the shareholders testified they were unhappy with their commercial insurance policies, but Peak continued to maintain its commercial coverage after Reserve was established.

During 2008-2010, Reserve issued 13 direct policies to Peak and two affiliated corporations in exchange for annual premiums of $400,000. There were multiple issues with the direct policies, including that several policies listed the wrong insured and other policies overlapped with Peak's existing commercial coverage. Capstone advised Reserve it would have to receive at least 30% of its premiums from companies not affiliated with it to qualify as an insurance company. To this end, Reserve participated in a quota share reinsurance policy with PoolRe, a risk pool involving 50 captive insurance companies Capstone managed. Under this arrangement, Reserve and other Capstone entities agreed to assume a portion of the risks PoolRe assumed. The policy was structured so that the fees Reserve received from PoolRe equaled the fees PoolRe received from Peak. Additionally, Reserve entered a credit co-insurance arrangement with PoolRe involving CreditRe. There was no evidence that Reserve received any premiums in connection with the credit co-insurance arrangement.

Peak deducted the insurance premiums it paid to Reserve as business expenses on its federal income tax returns. Because Reserve received premiums less than $600,000 each year, it concluded it was a tax-exempt insurance company under I.R.C. § 501(c)(15) and paid no tax on the premium payments it received from Peak. The IRS determined that Reserve was not entitled to exclude the premiums from taxation and proposed assessments for each year.

Legal Analysis

I.R.C. § 501(c)(15)(A)(i) provides that insurance companies are tax exempt where: (i) the gross receipts for the year do not exceed $600,000; and (ii) more than 50% of the gross receipts consist of premiums. The central issue in *Reserve Mechanical* was whether Reserve was an insurance company such that it could benefit from the tax exemption in § 501(c)(15).[3] Insurance is not defined by the Internal Revenue Code. Courts have adopted a four-part framework for evaluating insurance arrangements: (i) the arrangement must involve insurable risks; (ii) the arrangement must shift the risk of loss to the insurer; (iii) the insurer must distribute the risk of loss among its policy holders; and (iv) the arrangement must constitute insurance in the commonly accepted sense.[4]

Applying this framework, the Tax Court concluded that the Reserve arrangement was deficient on two grounds: (i) it did not provide for risk distribution because the direct policies involved too few insureds and PoolRe was not a bona fide insurance company; and (ii) it was not insurance in the commonly accepted sense because Reserve was not operated as an insurance company and the premiums were unreasonable and not actuarily determined. The Tenth Circuit affirmed the Tax Court's ruling on both grounds. Each ground is discussed below.

(i) The Reserve Arrangement Did Not Provide for Risk Distribution

On appeal, Reserve did not dispute the Tax Court's conclusion that the direct policies issued to Peak did not result in risk distribution. Rather, it argued the reinsurance and co-insurance arrangements with

[3] T.C. Memo 2018-86 (2018).
[4] *Harper Grp. v. Comm'r*, 96 T.C. 45 (1991), aff 979 F.2d 1341 (9th Cir. 1992).

PoolRe resulted in sufficient risk distribution for Reserve to be a valid insurance company. Reserve claimed the Tax Court misapplied the test for risk distribution by focusing on whether PoolRe was a bona fide insurance company. The Tenth Circuit acknowledged that, in theory, an arrangement that provided for the distribution of risk could be insurance even where there was no insurance company. However, PoolRe's product was not insurance. According to the court, the reinsurance arrangement amounted to nothing more than a circular flow of funds with no meaningful distribution of risk. Moreover, there was no evidence that the co-insurance arrangement with PoolRe even existed because it did not receive any premiums or pay any claims during 2008-2010. But, even if the co-insurance did exist, Reserve did not assume any meaningful risk. According to the Tenth Circuit, the Tax Court understated the evidence that PoolRe was a sham. The Tenth Circuit noted that the Tax Court decision did not reach a conclusion about the legitimacy of risk pooling in general. But it was clear that PoolRe's risk pool did not result in the distribution of risk.

(ii) The Reserve Arrangement Was Not Insurance in the Commonly Accepted Sense

On appeal, Reserve argued the Tax Court erred in: (i) mischaracterizing the policies as excess coverage policies; (ii) concluding that the premiums were unreasonable and not negotiated at arm's length; and (iii) holding that Reserve was not operated as an insurance company because it was managed by Capstone. The Tenth Circuit disagreed. First, it concluded that the Tax Court had not misread the direct policies Reserve issued to Peak. It was clear the direct policies only applied after all other insurance coverage was exhausted. Second, the Tax Court properly concluded that the policy premiums were unreasonable and not negotiated at arm's length because the premiums were four times higher than Peak's commercial policies and Reserve provided no explanation for how it calculated the risks. Finally, the Tax Court was justified in concluding that Reserve was not operated as an insurance company because it had no employees; never conducted business in Anguilla; its president knew nothing about its operations; and it failed to investigate the only claim it received before paying out approximately $340,000. Therefore, it was clear the Reserve policies were not insurance in the commonly accepted sense.

Conclusion

Reserve's direct policies and PoolRe's risk pool involved numerous defects specific to this case. But *Reserve Mechanical* may reinforce the IRS's resolve to shut down abusive micro-captive transactions. Although the court stated it was not reaching an opinion on the legitimacy of risk pooling in general, the case sets a high bar for micro-captive insurance companies to establish risk distribution. Taxpayers who are participating in micro-captive transactions may wish to consult with their tax advisor to understand how *Reserve Mechanical* affects them.

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