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Insurance: Tax Court sides with IRS, rejects captive's insurance company status

The U.S. Tax Court this week found that a corporation was not a captive insurance company, but rather a foreign corporation subject to the 30% withholding tax on its "fixed or determinable annual or periodical" (FDAP) income imposed by section 881(a)(1).

The case is: *Reserve Mechanical Corp. v. Commissioner*, T.C. Memo* 2018-86 (June 18, 2018). Read [T.C. Memo. 2018-86](#) [PDF 220 KB]

*A Tax Court Memorandum Opinion is an opinion issued by the Tax Court in a case with respect to which the law is settled or factually driven (i.e., in a case which does not involve a novel legal issue). A Tax Court Memorandum opinion may be cited as precedent.

Background

The taxpayer (Reserve) was incorporated in Anguilla in 2008 and was licensed and regulated as an insurance company. Reserve was 100% owned by Peak Casualty Holdings, LLC, which in turn was owned by two U.S. citizen individuals with each possessing a 50% interest. These individuals were also each 50% owners of Peak Mechanical & Components, Inc. ("Peak"), an Idaho S corporation engaged in the business of distributing, servicing, repairing, and manufacturing equipment used for underground mining and construction.

The two individuals engaged Capstone Associated Services, Ltd. ("Capstone") to advise on the formation of Reserve as a captive insurance company, to prepare a feasibility study for Reserve, and to serve as Reserve's administrator. Reserve was formed to issue direct written insurance policies to Peak and two affiliated entities with minimal operations. Reserve made a section 953(d) election to be treated as a domestic corporation for federal tax purposes and operated as a tax-exempt nonlife

insurance company with fewer than \$600,000 of gross receipts, pursuant to section 501(c)(15).

Reserve's direct written policies provided Peak and the two affiliates with coverage in excess of the coverage provided by third-party insurers. Between 2008 and 2010, Reserve issued 13 types of policies to the three insureds, covering risks such as director and officer, loss of a major customer, weather-related business interruption, product recall, and pollution liabilities. The aggregate amount of insurance provided ranged from \$8 million to \$13 million annually over that time span, and all three insureds were listed on each policy despite the fact that Peak's two affiliates had no employees and minimal operations.

In addition to its direct business, Reserve participated in a quota share reinsurance pool with PoolRe Insurance Corp. ("PoolRe")—the stop-loss insurer listed on each of Reserve's direct policies. Like Reserve's, PoolRe's operations were administered by Capstone. PoolRe pooled the premiums that it was entitled to receive under its stop loss agreements with Reserve and other Capstone-advised entities, and executed quota share reinsurance agreements to redistribute the risks to each participating Capstone entity.

Reserve also participated in a coinsurance arrangement pursuant to which Reserve assumed a small portion of PoolRe's risk with respect to a large pool of vehicle service contracts ceded to PoolRe by CreditRe Reassurance Corp. Ltd. ("CreditRe"), an unrelated company. PoolRe executed similar coinsurance contracts with other Capstone entities during the tax years in issue.

As an insurance company exempt from tax under section 501(c)(15), Reserve filed either Form 990-EZ or Form 990 from 2008 to 2010.

In 2016, the IRS issued a notice of deficiency for these years, claiming that Reserve was not an insurance company within the meaning of the subchapter L of the Internal Revenue Code. As such, the IRS asserted that Reserve was not eligible to make a section 953(d) election and instead was to have been taxed as a foreign corporation, filing Form 1120-F and paying the required 30% withholding tax on its FDAP income.

Tax Court's decision

The Tax Court sided with the IRS and sustained the IRS's assessment of tax. In its analysis, the Tax Court looked to the four criteria commonly used in case law, most recently in *Avrahami v. Commissioner*, to determine whether a particular transaction constitutes insurance for federal income tax purposes. The Tax Court provided analysis for only two of the criteria, and determined that Reserve did not satisfy either criterion.

Risk distribution

The risk distribution requirement is generally fulfilled if the insurer is deemed to pool a sufficiently large number of unrelated risks in order to minimize the possibility that a single claim will exceed the total amount taken in as premiums and set aside for payment for such claim. The Tax Court determined that Reserve did not sufficiently distribute risk because at any given time, Reserve had issued a maximum of 13 direct written policies to three insureds (two of which had minimal operations).

Though Reserve also participated in the aforementioned quota share reinsurance and vehicle service contract coinsurance arrangements, the Tax Court concluded that these arrangements could not support Reserve's assertions of adequate risk distribution largely because it determined PoolRe was not a bona fide insurance company.

The Tax Court noted that while the reinsurance agreements lent the appearance of risk distribution, a number of factors disqualified them from being classified as bona fide insurance arrangements. The Tax Court observed that the reinsurance agreements resulted in a flow of funds that was almost completely circular; under the agreements Reserve would receive payments from PoolRe in exactly the same amount as the payments that PoolRe was entitled to receive from Peak for the stop loss coverage. It was also noted that the reinsurance premiums were calculated under a flat-rate, "one-size-fits-all" structure and were not actuarially determined on an arm's length basis. The Tax Court also appeared to question whether the reinsurance transactions related to actual and insurable risks because PoolRe became liable for claims only after substantial loss thresholds were exceeded for Peak's extensive third-party insurance coverage. The Tax Court determined that the only purpose that PoolRe served was to shift income from Peak to tax-exempt Reserve. The Tax Court held that Reserve did not establish that PoolRe was created for legitimate nontax business reasons.

Additionally, the Tax Court concluded that any risk assumed through the coinsurance arrangements was minimal because PoolRe assumed only a small, blended portion of the overall vehicle service contract pool. The amount of PoolRe's portion ceded to Reserve was also determined to be de minimis because PoolRe ceded only about 1% of its share of the risk to Reserve.

Insurance in the commonly accepted sense

The Tax Court also held that the transactions between Reserve and its insureds did not constitute "insurance in the commonly accepted sense." Several factors were considered in making this determination. For instance, the two individuals—the only parties with a financial interest in Reserve—appeared to have performed no due diligence related to any policies that Reserve issued. Substantially all facets of Reserve's business were managed by Capstone, which also managed PoolRe. Capstone's feasibility study was considered inadequate and was not even complete when Reserve issued its first policies.

Additionally, only one claim was filed under Reserve's direct written policies. No supporting documentation was obtained to substantiate the occurrence or the amount

of this claim, and the first payment made with respect to the claim was made before the execution of a settlement and release agreement. Only years later was this documentation amended to account for subsequent claim payments. As described above, premiums for the policies were not actuarially determined and did not appear to be calculated at arm's length because they were not commensurate with the minimal risks assumed by Reserve. The Tax Court ultimately concluded that Capstone directed Reserve's activities and a series of transactions between its managed entities so that Reserve appeared to be engaged in the business of issuing insurance contracts.

KPMG observation

Given the facts of the case, tax professionals note that the Tax Court's memorandum opinion was not ground-breaking. The Tax Court cited *Avrahami v. Commissioner* heavily throughout its opinion, which is not surprising considering the similarities between certain aspects of each case—such as the almost circular flow of funds and the number of entities across which risk was distributed.

The Tax Court's discussion regarding the presence of risk distribution in an insurance arrangement may be cited in the future, though its usefulness is limited because Reserve's policies would not have been considered insurance in the commonly accepted sense even had the risk been adequately distributed.

In addition, the opinion may be cited by the IRS in the future because other decisions were not as expansive in their discussion of an absence of non-tax business purposes underlying the creation and operation of the captive insurance company.

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