



June 25th, 2018

T.C. Memo 2018-86

Summary of the Tax Court Decision for Reserve Mechanical Corp. Filed June 18th, 2018

Summary:

The Tax Court determined that transactions in which a foreign captive insurance company participated in were not insurance contracts for Federal income tax purposes.

Facts:

Reserve was formed as an insurance company in 2008 in Anguilla. In 2008 and 2009 Reserve wrote premium and issued insurance policies with three named insureds on each policy. The premiums were priced internally and the policies issued appear to cover risks that some of the insureds did not have. The policies issued by Reserve did not separately price premium by insured and instead listed just one premium price. The policies issued only provided coverage in excess of coverage provided by other third-party commercial carriers.

PoolRe Insurance Corp. was listed as the stop loss insurer on each policy. PoolRe issued stop loss endorsements for about 55 entities (before licensure in Anguilla) and agreed to assume risks only once a significant threshold was met.

The owners of Reserve had almost no knowledge of the company's operations or policies, how claims would be handled, or where records were kept. Reserve had a feasibility study conducted, but the report was not received until well after the time the company issued its first policies.

Conclusion:

The Court determined the policies were not suited to the needs of insureds and the number of insureds and independent exposures covered under the policies did not distribute the assumed risk. Similar to *Avrahami*, Reserve did not achieve risk distribution through the policies issued for its affiliated entities.

Further, the Court determined PoolRe was not a bona fide insurance company because it did not successfully distribute risk through its reinsurance agreements since PoolRe was liable for claims only after a significant threshold was met.

The Court also determined that Reserve's quota share policies with PoolRe were not bona fide insurance agreements. All participants in the quota share arrangement with PoolRe were required to pay the same percentage of premiums to PoolRe and there was no evidence the premiums were actuarially determined. It was determined that PoolRe's activities were not those of a bona fide insurance company in the commonly accepted sense.

Comparison of Reserve Mechanical to Oxford Program:

| <u>Reserve Mechanical</u> | <u>Oxford Program</u> |
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| Policies not suited to needs of insureds | Detailed risk analysis prior to formation identifies applicable risks for the operating company |
| Pricing of policies conducted in-house | Use of Best in Class 3 rd party actuaries |
| No explanation of how premiums divided between related/unrelated | First dollar pool provides clear connection between allocation |
| Feasibility study not completed until well after captive's operations began | Feasibility studies produced and delivered to regulators as part of the captive application |
| Pool Re wrote insurance before licensure in Anguilla | All Oxford fronting carriers are properly licensed in their respective domiciles from day one |
| No pooled losses | Due to first-dollar pool, every loss is a pooled loss |
| Client unable to discuss captive program intelligently | Robust client education program, including compliance and annual business meeting, newsletters, and seminars |
| No due diligence on related party claim | Formal, documented claims procedure with checks and balances |