**Reserve Mechanical Corp v Comm:**

**A Potential Death Knell for Aggressive Captive Insurance**

**Beckett Cantley[[1]](#endnote-1)**

**Geoffrey Dietrich[[2]](#endnote-2)**

This article provides an overview of the May 13th, 2022, U.S. Tenth Circuit Court of Appeals decision in *Reserve Mechanical Corp. v. Commissioner*,[[3]](#endnote-3) and analyzes its likely impact on the aggressive captive insurance company (“CIC”) industry. A much longer and broader discussion of this topic will be published in our forthcoming article in the U.C. Davis Business Law Journal.

*Introduction*

A storm has been brewing in the tax world, and there may be no safe harbor in sight for participants in aggressive captive insurance schemes. On May 13th, 2022, the U.S. Tenth Circuit Court of Appeals handed down a major defeat to one of these aggressive captive insurance schemes.[[4]](#endnote-4) In a landmark case, *Reserve Mechanical v. Commissioner*,[[5]](#endnote-5) the Court found that the transactions that the CIC Reserve Mechanical had engaged in were not insurance and therefore Reserve Mechanical was not an insurance company. As a result, Reserve Mechanical could not take advantage of the federal income tax exemption under Internal Revenue Code (“IRC”) Section 501(c)(15). This tax exemption allows a CIC to not pay tax on whatever premiums are paid to it, up to a certain threshold.[[6]](#endnote-6) Tax planners would be paid to set up CICs for business owners and the business owners would then pay premiums to the new CIC while the CIC books those premiums as tax exempt income. These premiums are often determined without actuarial data and with a poorly produced risk pool consisting of other CICs managed by the tax planners engaged in the scheme.[[7]](#endnote-7)

*Benefits of CICs*

With correct planning CICs stand to obtain favorable tax treatment under IRC Sections 501(c)(15) and 831(b). This creates a tax exemption for insurance companies whose gross receipts for the tax year do not exceed $600,000 under IRC Section 501(c)(15)[[8]](#endnote-8) or $2.3 Million under IRC Section 831(b).[[9]](#endnote-9) These exemptions are treated identically with the only difference being the level of exemption permitted under the statute. The use of CICs for businesses with a true and real economic need for them does not, in and of itself, constitute an abusive tax transaction. However, despite the real economic circumstances that would call for the use of CICs, the practices of several tax planners in the CIC world have become flagrantly abusive. This abuse has colored CICs in the IRS’ eyes such that even those who have a very real need for the use of CICs may become potential targets of IRS audits.[[10]](#endnote-10)

*The U.S. Tax Court Case*

The original *Reserve Mechanical Corp. v. The Commissioner* case came down before the U.S. Tax Court on June 18th, 2018.[[11]](#endnote-11) Reserve Mechanical Corp (“Reserve”) was a CIC formed to insure Peak Mechanical & Components Inc. (“Peak”). As a CIC, Reserve was owned by the same people that owned Peak. The three issues at hand in this case were (1) whether the transactions that Reserve engaged in were insurance resulting in the right to the IRC Section 501(c)(15) exemption; (2) whether Reserve was a domestic corporation under IRC Section 953(d); and (3) if Reserve was not an insurance company and did not make a valid IRC Section 953(d) election, whether it could be taxed 30%. This article will only address the first question as to whether or not Reserve was an insurance company. In the IRS’s view, Reserve was solely created so that the owners of Peak could take advantage of the tax deduction and Reserve could take advantage of the tax exemption, rather than because Peak needed insurance that it could not get elsewhere, and thus the transactions Reserve engaged in lacked economic substance.[[12]](#endnote-12)

The IRS’s assessment that Reserve was not an insurance company was based on several factors. The first, was that the transactions that Reserve engaged in constituted a circular flow of funds.[[13]](#endnote-13) Peak would pay premium payments to Reserve for direct coverage. Reserve would then take these premiums and pay them to the CIC risk pool, PoolRe, as reinsurance by attempted risk distribution across a number of other CICs also paying into the risk pool. Peak would then also pay premiums to PoolRe in exchange for stop-loss insurance from PoolRe. Lastly, PoolRe would pay the same stop-loss premium amount it received from Peak to Reserve to insure the same stop-loss coverage it had with Peak. The court determined that the flow of premiums between these three entities constituted an improper circular cash flow of funds.

Next, the IRS focused on how the premiums that Reserve charged were determined. Several experts testified that they had used actuarial tables to calculate them but could not provide those tables and could not explain how Reserve somehow managed to charge each year the exact amount of premiums that would result in the greatest tax exemption for the CIC.[[14]](#endnote-14) The IRS argued that premium calculation method used was bogus.

The Tax Court ruled in favor of the IRS and held that Reserve did not issue insurance contracts. Thus, Reserve was not an insurance company, and was thereby ineligible for the Section 501(c)(15) exemption.[[15]](#endnote-15) Therefore, the premiums that Reserve received were now treated as investment income and could be taxed at a 30% withholding rate. The Tax Court determined that the premiums that were paid to Reserve by Peak and then to PoolRe and vice versa constituted a circular cash flow of funds. They also determined that the premiums paid were determined by what would produce the greatest tax deduction rather than based on actuarially determined insurance need. The Tax Court noted the strangeness of some of the facts of Reserve. For instance, after Peak formed Reserve its insurance costs went up 400%.[[16]](#endnote-16) In the Tax Court’s estimation there is no reasonable and ordinary explanation for why a company would increase its insurance costs by such a staggering amount. After the Tax Court decision, Reserve was appealed to the Tenth Circuit Court of Appeals.[[17]](#endnote-17)

*The 10the Circuit U.S. Court of Appeals Decision*

The Tenth Circuit ruled in favor of the IRS on all issues. The Tenth Circuit’s ruling against Reserve was damning. In the words of the court:

Reserve has not presented *any argument* as to why a factfinder could not infer that Peak’s intent was simply the intent to create a plausible insurance company through which Peak could obtain a substantial tax deduction without reducing the funds available to its two owners. The intent behind the act does not change just because the act failed to achieve its purpose.[[18]](#endnote-18) [Emphasis added]

The Tenth Circuit’s comments make it clear that it does not see Reserve as being run like a legitimate business. The court found that there was no evidence of any reasonable risk assessments to determine whether Peak needed any of the additional policies. The court noted that Reserve prepared policies that only lasted for a month in a rush to obtain a large business deduction for Peak in 2008, and that this behavior was “laughable”.[[19]](#endnote-19) The Tenth Circuit also held that the re-insurance policies that Reserve held with PoolRe did not distribute risk and that if anything the previous Tax Court decision understates the compelling evidence that these re-insurance arrangements were a “sham”.[[20]](#endnote-20) The Tenth Circuit held that they would have emphasized different evidence than the Tax Court, but that the Tax Court’s conclusions were supported by overwhelming evidence in the record.

No experience, expertise, or studies supported the need for Peak to obtain the issued policies.[[21]](#endnote-21) Further, the Tenth Circuit found that Reserve raised no persuasive challenges to the Tax Court’s conclusion.[[22]](#endnote-22) Despite one of Reserve’s expert witness’ testimony that commercial insurance policies were available as an alternative to several of the Reserve policies, Reserve provided no evidence that anyone compared the rates on such policies or otherwise considered industry standards in determining its premium rates. Instead, the record suggests that Reserve based the rates on the premiums charged by other captive insurers managed by Capstone.[[23]](#endnote-23)

The Tenth Circuit doubted the actuarial methodology used to determine the premiums, and determined that these insurance contracts were not negotiated at arm’s length.[[24]](#endnote-24) The many inconsistencies in Reserve’s business practices made it impossible for the Tenth Circuit to take seriously Reserve’s claim that it was a bona fide insurance company engaged in the business of insurance. As a result, the Tenth Circuit’s decision that Reserve’s policies were not actual insurance feels like a layup and the intensity of the court’s contempt for this aggressive CIC program should be very concerning to other similarly situated CIC owners.

*Conclusion*

The 10th Circuit decision in *Reserve Mechanical* was a major boost in the IRS’s overall attack on aggressive CIC tax programs. If *Reserve* had won on appeal, then the aggressive CIC industry would have at least one major case to stand on. The IRS’s *Reserve Mechanical* win was the biggest in a line of IRS wins in cases on similar grounds. As such, the aggressive CIC industry must either change its ways or close up shop, because the IRS appears determined to shut it down one way or another, and the judiciary is giving it all the ammunition it needs to do so.

1. Prof. Beckett Cantley (University of California, Berkley, B.A. 1989; Southwestern University School of Law, J.D. cum laude 1995; and University of Florida, College of Law, LL.M. in Taxation, 1997), teaches International Taxation at Northeastern University and is a shareholder in Cantley Dietrich, LLC. Prof. Cantley would like to thank Melissa Cantley and his law clerk, Beckett L. Cantley, for their contributions to this article. [↑](#endnote-ref-1)
2. Geoffrey Dietrich, Esq. (United States Military Academy at West Point, B.S. 2000; Brigham Young University Law School, J.D. 2008) is a shareholder in Cantley Dietrich, LLC. [↑](#endnote-ref-2)
3. *Reserve Mech. Corp. v. Comm'r*, T.C. Memo. 2018-86 (U.S.T.C. Jun. 18, 2018). [↑](#endnote-ref-3)
4. *Reserve Mech. Corp. v. Comm'r of Internal Revenue*, 34 F.4th 881 (10th Cir. 2022), https://www.ca10.uscourts.gov/sites/ca10/files/opinions/010110683986.pdf [↑](#endnote-ref-4)
5. *Id.* [↑](#endnote-ref-5)
6. IRC § 501(c)(15). [↑](#endnote-ref-6)
7. *Reserve Mech. Corp. v. Comm'r*, T.C. Memo. 2018-86 (U.S.T.C. Jun. 18, 2018) at p. 42, https://www.ustaxcourt.gov/opinions/2018/TCMemo\_2018-86.pdf [↑](#endnote-ref-7)
8. IRC § 501(c)(15). [↑](#endnote-ref-8)
9. IRC § 831(b). [↑](#endnote-ref-9)
10. Notice 2016-66. [↑](#endnote-ref-10)
11. *Reserve Mech. Corp. v. Comm'r*, T.C. Memo. 2018-86 (U.S.T.C. Jun. 18, 2018) at p. 1, https://www.ustaxcourt.gov/opinions/2018/TCMemo\_2018-86.pdf [↑](#endnote-ref-11)
12. *Id*. at p. 4. [↑](#endnote-ref-12)
13. *Id*. at p. 41. [↑](#endnote-ref-13)
14. *Id*. at p. 44. [↑](#endnote-ref-14)
15. *Id*. at p. 43. [↑](#endnote-ref-15)
16. *Id*. at p. 58. [↑](#endnote-ref-16)
17. *Reserve Mech. Corp. v. Comm'r of Internal Revenue*, 34 F.4th 881 (10th Cir. 2022), https://www.ca10.uscourts.gov/sites/ca10/files/opinions/010110683986.pdf [↑](#endnote-ref-17)
18. *Reserve Mech. Corp. v. Comm'r of Internal Revenue*, 34 F.4th 881 (10th Cir. 2022), [↑](#endnote-ref-18)
19. *Id.* At p. 60. [↑](#endnote-ref-19)
20. *Id.* At p. 57. [↑](#endnote-ref-20)
21. *Id.* At p. 54. [↑](#endnote-ref-21)
22. *Id.* At p. 54. [↑](#endnote-ref-22)
23. *Id.* At p. 19. [↑](#endnote-ref-23)
24. *Id*. at p. 64. [↑](#endnote-ref-24)