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RESERVE MECHANICAL CORP. F.K.A. RESERVE CASUALTY CORP.,

Petitioner,

ELECTRONICALLY FILED

v.

Docket No. 14545-16

COMMISSIONER OF INTERNAL REVENUE,

Respondent

PETITIONER'S MOTION FOR RECONSIDERATION OF FINDINGS OR OPINION PURSUANT TO RULE 161

UNITED STATES TAX COURT

RESERVE MECHANICAL CORP. F.K.A. RESERVE CASUALTY CORP.,	)	
Petitioner,	)	
v.	)	Docket No. 14545-16
COMMISSIONER OF INTERNAL REVENUE,	)	Filed Electronically
Respondent.	)	JUDGE KATHLEEN KERRIGAN

PETITIONER'S MOTION FOR RECONSIDERATION

PETITIONER MOVES THE Court, pursuant to Rule 161,[1] to reconsider its Memorandum Findings of Fact and Opinion filed June 18, 2018 (T.C. Memo. 2018-86)(the "Opinion") as to the amounts received by Petitioner designated as insurance premiums during the tax years 2008, 2009 and 2010 being subject to tax under Section 881(a)(1).[2]

IN SUPPORT THEREOF, Petitioner respectfully shows unto the Court as follows:

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[1] Unless otherwise indicated, all Rule references are to the Tax Court Rules of Practice and Procedure and all section references are to the Internal Revenue Code of 1986, as amended, and Treasury Regulations thereunder, as in effect for and applicable to the years in issue.

[2] Petitioner's Motion for Reconsideration only addresses the Section 881 tax issue and is not intended to suggest that Petitioner concedes any of the Court's other factual findings or legal conclusions in the Opinion are correct. Petitioner reserves the right to address these other factual findings or legal conclusions at a later date.

I. Introduction

On June 18, 2018, the Court issued the Opinion sustaining, inter alia, Respondent's determination that Petitioner is liable for tax computed under Section 881 for the amounts that it received as insurance and reinsurance premiums during 2008, 2009 and 2010.[3] Specifically, the Court held that Petitioner is liable for such tax because Petitioner had not demonstrated that such amounts were not "fixed or determinable annual or periodical" income ("FDAP income") from sources within the United States that are subject to the 30 percent tax under Section 881. Because the Court's finding that the amounts received by Petitioner as gross premiums (unreduced by any expenses) constituted FDAP income is inconsistent with the Court's other findings in the Opinion and well-established legal principles, Petitioner respectfully moves the Court to reconsider and revise its findings regarding this issue.

II. Argument and Analysis

The Court should exercise its discretion to grant Petitioner's Motion for Reconsideration because the Court substantially erred in finding that the amounts received by

[3] Respondent conceded that reinsurance premiums from co-insurance arrangements involving Credit Reassurance Corporation, Ltd. ("CreditRe") were not taxable under Section 881. See Opinion, p. 64. The co-insurance premiums subject to this concession were $69,500, $76,500 and $66,000 for tax years 2008, 2009 and 2010, respectively.

Petitioner designated as insurance premiums during the tax years 2008, 2009 and 2010 were subject to tax under Section 881(a)(1), and that error is material to the decision of the instance case.[4]

In the Opinion, the Court held that Petitioner was not an insurance company for federal tax purposes and that the premiums that Petitioner received were not insurance premiums.[5] In making these findings, the Court held that Petitioner had not demonstrated that (a) there was a valid non-tax reason for the insurance arrangements that Petitioner entered into during the years at issue,[6] (b) Petitioner was operated as a bona fide insurance company during the years at issue,[7] and (c) Petitioner's insureds had a bona fide non-tax reason for paying premiums to Petitioner.[8] The Court further held that any amounts that were paid by the insureds to PoolRe Insurance Corp. ("PoolRe") under the Stop Loss Agreements and then by PoolRe to Petitioner under the Quota Share Policies were nothing more than

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[4] See Vaughn v. Comm'r, 87 T.C. 164, 166-67 (1986) (discussing motions for reconsideration where substantial error or unusual circumstances exist); Stoody v. Comm'r, 67 T.C. 643, 644 (1977); CWT Farms, Inc. v. Comm'r, 79 T.C. 1054, 1057 (1982).

[5] See Opinion, pp. 62-63.

[6] Id. at p. 62. The Court, referring to Petitioner, found that "it was not operated as a bona fide insurance company, and there was no legitimate business purpose for the policies that Reserve issued for the insureds." Id.

[7] Id.

[8] Id. at p. 60. The Court states that "[t]he facts do not reflect that Peak had a genuine need for acquiring additional insurance during the tax years in issue." Id.

a circular flow of funds designed to reduce the income tax liabilities of Petitioner's insureds (or their owners).[9] The Court also held that there was no valid business reason for the existence of non-party PoolRe.[10] In short, the Court held that there was no valid non-tax business reason for Petitioner to have received any of the premiums at issue.

The Court then held that Petitioner had income as a result of the receipt of the premiums at issue, finding that Petitioner had not established that the amounts received were not taxable.[11] The Court's holding is inconsistent with the Court's finding that there was no valid non-tax reason for Petitioner to have received the premium amounts and with well-established legal principles.

A. If Petitioner had taxable income due to receiving payments from its insureds, there must be some non-tax reason for the insureds to make payments to Petitioner for the tax years in issue.

The premium payors in this case (the "insureds") were Peak Mechanical & Components, Inc. ("Peak"), RocQuest, LLC

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[9] Id. at pp. 41 and 45. At page 41, the Court states that "[i]n considering a very similar set of circumstances in Avrahami v. Commissioner, 149 T.C. at __ (slip op. at 68), we concluded that '[w]hile not quite a complete loop, this arrangement looks suspiciously like a circular flow of funds.'" At page 45, the Court opined that "[t]he only purpose PoolRe served through the quota share arrangement was to shift income from Peak to Reserve. Reserve has not established that PoolRe was created for legitimate nontax reasons."

[10] Opinion, p. 45.

[11] Id. at p. 64.

("RocQuest") and ZW Enterprises, LLC ("ZW"), all of which were co-equally owned by Norman Zumbaum and Cory Weikel.

The Court found that Petitioner was the recipient of the premiums paid by the insureds. In reaching this finding, the Court ignored PoolRe on the grounds that PoolRe had no non-tax business purpose.

Petitioner was owned by Peak Casualty Holdings, LLC ("Peak Holdings"), which was co-equally owned by Messrs. Zumbaum and Weikel. Thus, the structural relationship between the premium payors (the insureds) and the premium recipient (Petitioner) was that of brother-sister affiliates with common ownership.

For Petitioner to have income from payments made by the insureds in the entity structure before the Court, there must have been some non-tax reason for the payments to have been made by the insureds.[12] Otherwise, the payments would constitute distributions from the insureds to the owners of the insureds (i.e., Messrs. Zumbaum and Weikel) and a contribution by Messrs. Zumbaum and Weikel to the capital of Petitioner (through Peak

[12] See Rev. Rul. 78-83, 1978-1 C.B. 79, and cases cited therein ("[W]here property is transferred from one affiliate to a sister corporation without adequate consideration therefor, there is a constructive distribution to the common parent whether or not the motive for the transfer was an attempt improperly to allocate to income or deductions between the corporations"); see also Bittker & Eustice, Fed. Income Tax'n of Corps. & Shareholders, ¶¶ 8.06[10] (Warren Gorham & LaMont 2018), and cases cited therein; Rev. Rul. 2005-40, 2005-2 C.B. 4, discussed further below.

Holdings).[13] Any contrary analysis would be a concession that the arrangements under which the payments were made had at least some non-tax reason for being in existence, as further explained below.[14]

An illustration of the foregoing proposition is demonstrated by this Court's analysis and holding in Gulf Oil Corp. v. Commissioner.[15] In Gulf Oil, this Court held that payments made from Gulf to its captive insurance company (Insco) did not represent payments for insurance because there were not sufficient unrelated risks insured by Insco to achieve both risk shifting and distribution.[16] Nonetheless, this Court found that a business purpose existed for the insurance arrangements, including the payment of premiums to Insco and the payment of claims by Insco.

Respondent argued in Gulf Oil that payments of claims by Insco and the payment of premiums by Gulf's subsidiaries to Insco represented constructive dividends to Gulf.[17] This Court, however, disagreed with Respondent since Insco was organized and operated to provide Gulf with sufficient protection for certain risks of loss, thereby finding a business purpose for such

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[13] Id.

[14] Id.

[15] 89 T.C. 1010 (1987), aff'd, 914 F.2d 396 (3d Cir. 1990).

[16] Id. at 1026-27.

[17] Id. at 1029.

arrangements.[18] According to this Court, before it was willing to characterize a transfer of property from one corporation to another as a constructive dividend to a common owner, it was first necessary for the Court to examine the transfer under a two-part test set forth in Sammons v. Commissioner.[19] Under that test, this Court in Gulf Oil focused on whether the second part of the Sammons test had been met.[20] The second part of the Sammons test is subjective and asks whether the transfer was prompted by a business purpose of the transferor corporation or a shareholder purpose of the common owner. The transferor corporations in Gulf Oil had a business purpose for making the transfers and, therefore, this Court held that the second part of the test had not been satisfied.[21] This Court stated as follows:

> Although payments made by the foreign affiliates to Insco are not classified as deductible insurance premiums, nevertheless, such payments were for the benefit of the affiliates because they provided coverage for their risks as separate entities. While the payments made to this captive insurance company are equivalent to additions to a reserve for losses, Insco, nevertheless, represents a useful and legitimate tool in risk management. The same rationale applies to the payments of claims by Insco to the domestic affiliates. The payments were for the primary benefit of the affiliate which received them,

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[18] Id.

[19] 472 F.2d 449 (5th Cir. 1972).

[20] Gulf Oil, 89 T.C. 1010 at 1029-1030.

[21] Id.

> not for the benefit of the parent, Gulf. . . .
>
> Accordingly, we hold that the payments designated as premiums made by the foreign affiliates, and the payments of claims by Insco to Gulf and its domestic affiliates do not represent constructive dividends to Gulf.[22]

In other words, if there had been no business purpose for the payments of premiums to Insco, the payments of premiums to Insco by its sister affiliates would have been constructive distributions to Gulf (the common parent of both Insco and the sister affiliates paying premiums to Insco) followed by a contribution to the capital of Insco by Gulf. Moreover, if there had been no business purpose for the insurance arrangements at issue in Gulf Oil, the payment of insurance claims of Insco's sister affiliates (the insureds) by Insco would have also been a constructive distribution to Gulf by Insco and a contribution to the capital of the insured sister affiliates whose claims were being paid. This is consistent with Respondent's then-published position as set forth in Rev. Rul. 78-83,[23] which is still Respondent's published position and

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[22] Id. at 1030 (emphasis added).

[23] 1978-1 C.B. 79. The position in Rev. Rul. 78-83 is also consistent with Rev. Rul. 77-316, 1977-2 C.B. 53, amplified and clarified by Rev. Rul. 88-72, declared obsolete by Rev. Rul. 2001-31, 2001-1 C.B. 1348 (treatment of premium payments when premiums do not constitute insurance premiums). Rev. Rul. 77-316 cited Rev. Rul. 69-630, 1969-2 C.B. 112, for this proposition. Rev. Rul. 69-630 has not been withdrawn, modified or revoked.

should be his position in this case. This Court in Gulf Oil, however, found that there was a business purpose for the payments of premiums to Insco and the payments of claims by Insco to its insured sister affiliates, and found that the payments at issue were not constructive distributions to Gulf. If the Court had found no business purpose for the arrangements, the payments of premiums would necessarily have been constructive distributions to Gulf and contributions to capital to Insco. Insco could not have had any income if there had been no business purpose for the insurance arrangements because contributions to capital are not taxable income.[24]

The Court's analysis in Gulf Oil is consistent with Rev. Rul. 78-83 and is also consistent with Rev. Rul. 2005-40,[25] which sets forth Respondent's current position regarding the treatment of captive insurance arrangements that are not considered to be insurance for federal tax purposes. Rev. Rul. 2005-40 provides as follows:

> In order to determine the nature of an arrangement for federal income tax purposes, it is necessary to consider all the facts and circumstances in a particular case, including but not only the terms of the arrangement, but also the entire course of conduct of the parties. Thus, an arrangement that purports to be an insurance contract but lacks the requisite risk distribution may instead be characterized as a deposit arrangement, a loan, a

[24] This Court's opinion in Gulf Oil does not address whether the amounts received by Insco constituted taxable income to Insco.

[25] Rev. Rul. 2005-40, 2005-2 C.B. 4.

> contribution to capital (to the extent of net value, if any), an indemnity arrangement that is not an insurance contract, or otherwise, based on the substance of the agreement between the parties. The proper characterization of the arrangement may determine whether the insurer qualifies as an insurance company and whether amounts paid under the arrangement may be deductible.[26]

As this Court's analysis in Gulf Oil reflects, Petitioner here would have taxable income only if there were a non-tax reason for the payment of premiums by the insureds. In Gulf Oil, this Court held that such a non-tax reason existed for the premium payments from the insureds to Insco and the payment of claims by Insco even though Insco was found by this Court not to qualify as an insurance company for federal income tax purposes because of the absence of risk shifting and sufficient risk distribution.

Here, Respondent took the position in his notice of deficiency that there was no legitimate non-tax reason for Petitioner's receipt of insurance premiums, but also took the clearly inconsistent position that the amounts paid as premiums were nevertheless taxable income to Petitioner. Respondent's position is internally inconsistent and is inconsistent with Rev. Rul. 78-83.[27] The Court in its Opinion here has sustained Respondent's position on the grounds that there was no non-tax reason for the payment of premiums to Petitioner. The effect of

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[26] Id. (emphasis added).

[27] 1978-1 C.B. 79.

this is that the Court is allowing Respondent to take a position that is inconsistent with Rev. Rul. 78-83, which has not been modified or revoked and is still Respondent's published position. In doing so, the Court is disregarding its holding in Rauenhorst v. Commissioner[28] that when the treatment in a revenue ruling is favorable to taxpayers, the ruling is viewed as a concession by Respondent and is followed by the Court.[29] While Respondent may take inconsistent, whip-saw positions in different cases against different taxpayers, his taking inconsistent positions contrary to his own published rulings in the same case involving the same taxpayer is improper. Petitioner urges the Court to not allow Respondent to do that here.

In the Opinion, the Court held that there was no showing of a non-tax reason for the insurance arrangements and for the payments of premiums by the insureds to Petitioner. Thus, a finding by the Court that the premium payments somehow constitute income to Petitioner is inconsistent with the Court's holding on the insurance issues because a finding that the

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[28] 119 T.C. 157 (2002).

[29] Id. at 183; see also Beneficial Found., Inc. v. U.S., 8 Cl. Ct. 639, 645, 85-2 U.S.T.C. ¶ 9601 (1985) ("So long as published ruling is not revoked or modified, it may be invoked by any taxpayer as if it were issued to him personally and, to the extent that it addresses issues in his case, this ruling will normally be dispositive." (footnotes omitted)).

arrangements constituted some type of an arrangement to address risks that Peak, RocQuest and ZW faced would be inconsistent with the notion that there was no non-tax reason for the arrangements at issue. Thus, none of the premium payments from Peak, RocQuest or ZW can constitute income to Petitioner consistent with the Court's holdings regarding the insurance arrangements at issue in this case.

Under Rev. Rul. 2005-40, the finding of no business purpose for the arrangement precludes the finding of a loan, a deposit or an indemnity arrangement.[30] The Court's holding was that there was no business purpose for the payments here. Accordingly, Petitioner had no income as a result of the receipt of the premiums, which were contributions to capital of Petitioner.[31]

The Court held that Petitioner had failed to carry its burden of proof that the amounts were contributions to capital. Petitioner characterized its insurance arrangements as insurance for federal income tax purposes. The Court rejected this characterization, adopting Respondent's internally inconsistent position. As discussed above, once the Court held that there

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[30] See fn. 29 and related text concerning effect of Respondent's revenue rulings.

[31] See also Carnation Co. v. Comm'r, 71 T.C. 400, 415 (1978), aff'd, 640 F.2d 1010, 1013 (9th Cir.), cert. denied, 454 U.S. 965 (1981).

was no business purpose for the payments, the legal effect of this holding is that Petitioner had no income as a result of the receipt of the subject premiums.

B. Section 881 - Definition of FDAP Income and the Appropriate Characterization in this Proceeding

Section 881(a)(1) generally imposes a tax of 30 percent on FDAP income received by a foreign corporation from sources within the United States if the income is not effectively connected with the conduct of a U.S. trade or business. FDAP income includes interest, dividends, rents, salaries, wages, premiums, annuities, compensations, remunerations and emoluments. According to the regulations, FDAP income includes all income included in gross income under section 61, except for items specifically excluded by the regulations.[32] The U.S. payors of FDAP income are generally required to deduct and withhold therefrom an amount equal to the tax imposed by sections 881. See Sections 1441 and 1442. Pursuant to Section 1.1441-2(b)(2)(ii), the following item is not considered FDAP income under the regulations: "Any [other] income that [respondent] may determine, in published guidance (see § 601.601(d)(2) of this chapter), is not [FDAP] income."

Section 881(a)(1) lists U.S. source "premiums" as a type of FDAP income. Respondent has ruled that U.S. source insurance

[32] Section 1.1441-2(b)(1)(i).

premiums do not constitute FDAP income.[33] In the present case, however, this Court concluded that the premiums were not insurance premiums, but nonetheless otherwise constituted U.S. source income to Petitioner subject to tax under Section 881.[34]

As discussed above, the Court's holding was premised on the finding that there was no non-tax reason for the formation of Petitioner, the issuance of insurance policies, or the stop loss/quota share arrangement with PoolRe. Indeed, the Court held that the only purpose for non-party PoolRe's involvement was to provide for a circular flow of funds to reduce Petitioner's insureds' and their shareholders' U.S. taxable income. Moreover, as discussed above, if the amounts received by Petitioner were income under the Court's analysis, this means that the arrangements under which the amounts were paid have a non-tax reason for being in existence.

The Court repeatedly cited Avrahami in support of its analysis and holding. In Avrahami, this Court concluded that Feedback was not an insurance company and that the premiums that it received were not insurance premiums. The parties in Avrahami stipulated that the amounts received by Feedback in

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[33] See Rev. Rul. 80-222, 1980-2 C.B. 211; Rev. Rul. 89-91, 1989-2 C.B. 129.

[34] See Opinion, p. 66.

that case were not taxable under Section 881.[35] While this stipulation is not in effect in this case, Respondent's entering into such stipulation strongly suggests that Respondent recognized that the premiums, whether insurance for tax purposes or not, were not taxable to the foreign corporation in Avrahami under Section 881.

D. Amounts received by Petitioner from Peak, RocQuest and ZW should be treated as contributions to capital or nontaxable advances or deposits, consistent with Respondent's position in Rev. Rul. 2005-40

As discussed above, if the gross premiums received by Petitioner from Peak, RocQuest and ZW were not insurance premiums for federal income tax purposes, as the Court held, the amounts at issue that were received by Petitioner should be treated as contributions to capital or nontaxable advances or deposits consistent with Respondent's position in Rev. Rul. 2005-40. As further discussed above, the arrangement might be characterized as an indemnity arrangement, in which case, as in Gulf Oil, such an arrangement would have a non-tax business purpose and amounts paid for such indemnity arrangement would likely be income. The Court, however, in this case has held that there was no non-tax reason for the insureds to make the payments to Petitioner, so it would be difficult to find that the arrangements, though not insurance for tax purposes,

[35] 149 T.C. No. 7, at 88-89.

represented an indemnity arrangement because such an arrangement would be a legitimate risk management tool for the benefit of Petitioner's insureds. Moreover, if the arrangement were an indemnity arrangement, such an arrangement would likely be viewed as the provision of services, and those services (since they were performed by a foreign corporation and were performed in Anguilla) would not constitute U.S. source income, particularly since the Court also concluded that Petitioner was not engaged in a U.S. trade or business.[36]

The correct characterization of the amounts received by Petitioner from the insureds should be distributions from the insureds to the shareholders of such insureds and nontaxable contributions of capital to Petitioner by such shareholders and not subject to tax under Section 881(a)(1), as discussed above.

III. Conclusion

The Court should revise its Opinion consistent with the foregoing, i.e., if the amounts received by Petitioner are not

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[36] See Container Corp. v. Comm'r, 134 T.C. No. 5 (2010), aff'd without published opinion (5th Cir. 2011) (fees for guaranteeing debt are most analogous to income from services). Congress added Sections 861(a)(9) and 862(a)(9) to the Internal Revenue Code in response to Container Corp.

The Court could also analogize the payments to insurance premiums and source the payments like insurance premiums, but the Court has held that the amounts are not insurance premiums. See Sections 861(a)(7) and 862(a)(7); see also Bank of America v. U.S., 680 F.2d 142 (Ct. Cl. 1982).

insurance premiums, then such amounts are not income and not subject to tax under Section 881(a)(1).

Respondent's counsel have advised that they object to the granting of this motion.

WHEREFORE, it is prayed that this Court grant this motion and modify the Opinion to provide that the amounts received as insurance premiums by Petitioner are not subject to tax under Section 881(a)(1).

Respectfully submitted,

Dated: July 18, 2018

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