
Footnotes (Capstone Part 2: Commentary on Policy Pricing)

Does Captive Insurance Exist after the *Reserve* Decision?

1. Opinion at pages 6, 16-20.
2. See testimony of Donald J. Riggin, Trial Transcript at page 853 and pages 862-863 and Exhibit 136-R (Opening Expert Report of Donald J. Riggin, dated March 27, 2017). See also <https://www.verisk.com/insurance/products/commercial-lines-manual-clm-information-on-isonet/> and <https://www.verisk.com/about/#>.
3. See testimony of Donald J. Riggin, Trial Transcript at page 891.
4. See Trial Transcript at page 925 and Exhibit 136-R (Opening Expert Report of Donald J. Riggin, dated March 27, 2017).
5. See testimony of Lance McNeel, Trial Transcript at pages 323-361. Despite such, the court **both** concluded that: (i) "...Capstone calculated Reserve's premiums using objective criteria and what appears to be actuarial methods. ..." (See Opinion at page 61) and (ii) "the premiums charged for the policies were unreasonable". (See Opinion at page 62).
6. See testimony of Norman Zumbaum, Trial Transcript at pages 125-130. See also Exhibit 16-J (Feasibility Study for Reserve Casualty Corp.).
7. See testimony of Norman Zumbaum, Trial Transcript at page 123.
8. See testimony of Norman Zumbaum, Trial Transcript at page 107.
9. See testimony of Norman Zumbaum, Trial Transcript at page 106.
10. See testimony of Stewart A. Feldman, Trial Transcript at pages 765-769.
11. See Exhibit 125-P (Reserve Casualty Corp.'s Audited Financial Statements for the years ended December 31, 2009 and December 31, 2010).
12. See testimony of Gary Fagg, Trial Transcript at page 451. See also Exhibit 114-P (Expert Report of Gary Fagg, dated March 27, 2017).
13. The court, at page 61 of the Opinion, notes "With respect to premiums, the facts and circumstances of this case demonstrate that the direct written policies were not the result of arm's-length negotiations."
14. All section references are to the Internal Revenue Code of 1986 ("IRC" or the "Code"), as amended, and the Treasury Regulations promulgated thereunder, unless otherwise specified.
15. See Treas. Reg. Sec. 1.482-1 and Treas. Reg. Sec. 1.482-3. IRC section 482 provides the authority for the IRS to make allocations between controlled parties to clearly reflect the income of each of the parties in the case of two or more organizations, trades, or businesses owned or controlled directly or indirectly by the same interests. The arm's length standard is the standard the IRS has adopted for implementing the clear reflection of income principle for controlled transactions under IRC section 482. The arm's length standard is defined in the section 482 regulations. In determining whether the result of a controlled transaction is arm's length, taxpayers must use the method that, under the facts and circumstances, provides the most reliable measure of an arm's length result. This will be the best method. There is no

priority of methods and no method will invariably be considered to be more reliable than others. The regulations under section 482 do not prescribe any particular method for determining the pricing of an intercompany insurance transaction or an intercompany reinsurance transaction.

16. See note 4 *supra*.
17. See note 4 *supra*.
18. See testimony of Lance McNeel, Trial Transcript at pages 341-359.
19. See testimony of Stewart A. Feldman, Trial Transcript at page 639.
20. See testimony of Lance McNeel, Trial Transcript at pages 341-342, and Exhibit 109-P (Pricing Indications (for policy periods ending 12/31/08, 12/31/09/ and 12/31/10) prepared for Reserve Casualty Corporation by Mid-Continent General Agency, Inc., Underwriters at Lloyds of London)).
21. See note 5 *supra*.
22. See testimony of Donald J. Riggin, Trial Transcript at pages 862-863 and Exhibit 136-R (Opening Expert Report of Donald J. Riggin, dated March 27, 2017).
23. See testimony of Donald J. Riggin, Trial Transcript at page 910.
24. See testimony of Donald J. Riggin, Trial Transcript at pages 904-905 and Exhibit 138-P ("Captive Fundamentals" article authored by Donald J. Riggin and published on October 10, 2016). After reviewing Exhibit 138-P, Mr. Riggin admitted that a premium could be developed for a captive insurance company without having access to one of the "three permissible methods" that Mr. Riggin testified were the only permissible methods for determining insurance premiums. Mr. Riggin testified that these three "permissible methods" are: (1) using the Commercial Lines Manual (CLM), (2) using actuarial methodology based on actual loss data, and (3) using a wealth of information like a multi-line insurer would maintain in its files.
25. See testimony of Donald J. Riggin, Trial Transcript at pages 908-909.
26. See page 61 of the Opinion.
27. At page 60 of the Opinion, the court states "The facts do not reflect that Peak had a genuine need for acquiring additional insurance during the tax years at issue. There was no significant history of losses that would justify such a drastic increase..."
28. See Trial Transcript at page 988.
29. See page 61 of the Opinion.
30. At page 43 of the Opinion, the court states "As in *Avrahami v. Commissioner*, 149 T.C. at ____ (slp op. at 69), we are concerned with the one-size-fits-all rate for all the participants in the quota share arrangement."
31. See testimony of Lance McNeel, Trial Transcript at pages 368-372 and Exhibit 95-J (Letter from Steven Glicksman to Lance McNeel dated October 20, 2009, "Discussion of PoolRe's Coverage Options").

32. Id.
33. See pages 61-62 of the Opinion.
34. This actuarial analysis was from yet another Fellow of the Casualty Actuarial Society and Member of the American Academy of Actuaries and addresses the stop-loss arrangement.
35. See *Avrahami v. Commissioner*, 149 T.C. No. 7 (August 21, 2017).
36. See testimony of Esperanza Mead, Trial Transcript at pages 407-436, and Exhibit 113-P (Expert Actuarial Peer Review Report of Esperanza Mead dated March 10, 2017). See also testimony of Michael Solomon, Trial Transcript at pages 466-494, and Exhibit 117-P (Expert Actuarial Review Report of Michael Solomon dated March 27, 2017).
37. See testimony of Dr. Neil Doherty, Trial Transcript at pages 235-236 and Exhibit 104-P (Expert Report of Dr. Neil Doherty, dated March 27, 2017).
38. *Harper Gp. v. Commissioner*, 96 T.C. 45 (1991) at 59. Aff'd 979 F.2d 1341 (9th Cir. 1992).
39. Oliver Schofield, "*Reserve Mechanical: Judge Kerrigan Shows 'Limited Knowledge' of Reinsurance Market*," June 28, 2018. Mr. Schofield's article can be viewed [here](#). In this article, published by Captive Review, London reinsurance expert, Oliver Schofield, managing partner at risk and insurance consultancy RISCs, questions whether Judge Kerrigan fully understands the use and purpose of quota share contracts and explains that the stop loss "attachment point" in the PoolRe pooling arrangement was appropriate since the purpose of stop loss coverage is to serve as "protection against a catastrophic deterioration in loss frequency and as such should attach beyond the 1 in 10 year expected loss scenario." Mr. Schofield further explains that it is advisable for a captive to only retain a "distant aggregate excess of loss layer" to avoid "being taken to the 'mortuary chapel' by risks over which it has zero control or influence."
40. See testimony of Esperanza Mead (Trial Transcript at pages 407-436), testimony of Michael Solomon (Trial Transcript at pages 466-494), and testimony of Gary Fagg (Trial Transcript at pages 437-466).
41. See testimony of David Liptz, Trial Transcript at pages 520-595.
42. See testimony of Steve Kinion, Trial Transcript at pages 197-226.
43. See page 47 of the Opinion. The reinsurance premiums received by Reserve represented more than 30% of the total premiums that it received in each taxable year before the court.
44. See pages 46-47 of the Opinion, where the court stated as follows: "Reserve contends that liability for the pool of vehicle service contracts [which covered liabilities for such contracts that were pooled and ceded from Lyndon Property Insurance Co. (the direct issuer) to PoolRe and ultimately to Reserve] generated losses that offset premiums received during the tax years in issue. It failed to provide evidence that the vehicle service contracts, which formed the basis for the reinsurance that PoolRe re-ceded in the coinsurance contracts, actually existed." The court, apparently on its own, with the issue never being raised in the IRS audit, appeals or in the litigation, concluded that Lyndon's ceded insurance was not treaty reinsurance, but was instead facultative reinsurance and that Reserve or PoolRe should have individually underwritten each of the 100,000 policies rather than considering them as a single class. The court's basis for such a conclusion is unknown.
45. See Trial Transcript at page 458.