

**PUBLISH**

**UNITED STATES COURT OF APPEALS**

**FOR THE TENTH CIRCUIT**

**FILED**

**United States Court of Appeals  
Tenth Circuit**

**May 13, 2022**

**Christopher M. Wolpert  
Clerk of Court**

RESERVE MECHANICAL CORP., f/k/a  
Reserve Casualty Corp.,

Petitioner - Appellant,

v.

No. 18-9011

COMMISSIONER OF INTERNAL  
REVENUE,

Respondent - Appellee.

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ALABAMA CAPTIVE INSURANCE  
ASSOCIATION, INC.; ARIZONA  
CAPTIVE INSURANCE ASSOCIATION,  
INC.; DELAWARE CAPTIVE  
INSURANCE ASSOCIATION INC.;  
GEORGIA CAPTIVE INSURANCE  
ASSOCIATION, INC.; HAWAII  
CAPTIVES INSURANCE COUNCIL;  
KENTUCKY CAPTIVE ASSOCIATION,  
INC.; MISSOURI CAPTIVE  
INSURANCE ASSOCIATION;  
MONTANA CAPTIVE INSURANCE  
ASSOCIATION, INC.; NORTH  
CAROLINA CAPTIVE INSURANCE  
ASSOCIATION,; UTAH CAPTIVE  
INSURANCE ASSOCIATION; SELF  
INSURANCE INSTITUTE OF  
AMERICA,

Amici Curiae.

**Appeal from the Commissioner of Internal Revenue  
(CIR No. 014545-16)**

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Val J. Albright, Foley & Lardner, LLP, Dallas, Texas (Michelle Y. Ku, Foley & Lardner, LLP, Dallas, Texas, E. John Gorman, Logan R. Gremillion, and Coby M. Hyman, The Feldman Law Firm LLP, Houston, Texas, with him on the briefs) for the Petitioner-Appellee.

Geoffrey J. Klimas, Attorney, Tax Division (Richard E. Zuckerman, Principal Deputy Assistant Attorney General, Joshua Wu, Deputy Assistant Attorney General, Francesca Ugolini, Attorney, Arthur T. Catterall, Attorney, Tax Division, with him on the brief), Department of Justice, Washington, D.C., for Respondent-Appellee.

Elizabeth J. Bondurant (Jonathan Reid Reich, with her on the brief), Womble Bond Dickinson (US) LLP, Atlanta, Georgia, filed a brief for Amici Curiae The Alabama Captive Insurance Association, Inc., Arizona Captive Insurance Association, Inc., Delaware Captive Insurance Association Inc., Georgia Captive Insurance Association, Inc., Hawaii Captives Insurance Council, Kentucky Captive Association, Inc., Missouri Captive Insurance Association, Montana Captive Insurance Association, Inc., North Carolina Captive Insurance Association, Utah Captive Insurance Association, and Self Insurance Institute of America.

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Before **HARTZ**, **HOLMES**, and **PHILLIPS**, Circuit Judges.

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**HARTZ**, Circuit Judge.

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Reserve Mechanical Corp. appeals the decision of the Tax Court affirming the decision of the Commissioner of Internal Revenue that it did not qualify for an exemption from income tax as a small insurance company and that the purported insurance premiums it received must therefore be taxed at a 30% rate under I.R.C. § 881(a). We hold that the record supports the Tax Court's decision that the company was not engaged in the business of insurance. The court had two grounds for deciding that Reserve was not an insurance company. First, it determined that Reserve had not adequately distributed

risk among a large number of independent insureds—a hallmark of any true insurance company. Virtually all the insured risk was that of one insured, a company that had the same ownership as Reserve itself. To appear to distribute risk, Reserve entered into an insurance pool with other purported insurance companies, each owned by an affiliate of its insured, but the arrangement lacked substance and the pool itself did not distribute risk. Second, the Tax Court determined that the policies issued by Reserve were not insurance in the commonly accepted sense. For example, the premiums were not the result of arm’s-length transactions and were not reasonable, and Reserve was not operated in the way legitimate insurance companies operate. In addition, Reserve argues that if it was not an insurance company, the premiums it received must be treated as nontaxable capital contributions. We also reject that argument.

## I. OVERVIEW

From 2008 to 2010, when Reserve Mechanical Corp. was known as Reserve Casualty Corp., it issued a number of insurance policies to Peak Mechanical Corp. Two men, Norman Zumbaum and Cory Weikel, owned both Reserve (through Reserve’s parent corporation, Peak Casualty) and Peak. Before these policies were issued, Peak had limited its insurance coverage to commercial policies that cost about \$100,000 a year. Peak maintained those policies but also paid Reserve more than \$400,000 a year for the supplemental insurance obtained through the new policies. The relationship between Reserve and Peak is often termed “captive” insurance. *See* 3 Steven Plitt et al., *Couch on Insurance* § 39:2 (3d ed. 2021) (“A captive insurer is a corporation organized for the

purpose of insuring the liabilities of its shareholders or their affiliates.” (internal quotation marks omitted)).

Peak did not appear to get much in return for its \$400,000 annual payment to Reserve. The appellate record indicates that Peak recovered on only one loss, receiving a payment of slightly less than \$340,000; and even then, as we shall see, the bona fides of the claim were questionable and the handling of the claim was highly irregular. The high premiums on the policies could, however, be a significant financial benefit to Zumbaum and Weikel even if—indeed, especially if—Peak never suffered a loss covered by the policies issued by Reserve. The benefit arises from the tax treatment of small insurance companies, which has special consequences when the small insurer is a captive insurer, sometimes referred to as a “micro-captive.” As the Supreme Court recently explained:

A micro-captive transaction is typically an insurance agreement between a parent company and a “captive” insurer under its control. The [Internal Revenue] Code provides the parties to such an agreement with tax advantages. The insured party can deduct its premium payments as business expenses. And the insurer can exclude . . . those premiums from its own taxable income, under a tax break for small insurance companies. The result is that the money does not get taxed at all.

*CIC Servs., LLC v. IRS*, 141 S. Ct. 1582, 1587 (2021) (citations omitted). Thus, Peak could treat the \$400,000 in annual premiums it paid to Reserve as a deductible business expense on its federal income-tax returns, while Reserve would be exempt from income taxation so long as it qualified as an insurance company under the tax laws. (Reserve relied on I.R.C. § 501(c)(15), which exempts insurance companies from income taxation under § 501(a) if they receive no more than \$600,000 a year in premiums.) The \$400,000 moved from one entity owned by Zumbaum and Weikel to another entity they owned; so,

pre-tax, they had the same wealth despite the transfer. But their businesses paid significantly less tax. In particular, the more paid in premiums on the insurance policies, the greater the tax deduction, so there would be a strong financial incentive for those who owned both the business and its captive to set the premiums as high as possible, unlike the usual incentive for a business to reduce its expenses. Such tax benefits and incentives have led micro-captive transactions to come under scrutiny because of “their potential for tax evasion.” *CIC Servs.*, 141 S. Ct. at 1587.

Capstone Associated Services, Ltd., which consulted for and managed a number of captive insurance companies besides Reserve, advised Zumbaum and Weikel in creating Reserve and handled the technical and management issues, such as preparing policies and recommending premiums. It believed that for Reserve to be a qualified insurance company it would have to receive at least 30% of its premiums from companies not affiliated with it, a threshold we can assume to be correct for purposes of this appeal.

In the Background section of this opinion we will describe in some detail how Reserve purported to obtain this diversification of risks. But it may be useful to orient the reader by sketching the key aspects of the arrangement now. Capstone ostensibly created diversification of risks in two ways, which together accounted for about 30% of the “premiums” received by Reserve. First, it arranged for 50-some captives under its management to, in essence, be liable on reinsurance policies issued to each other. In a reinsurance relationship one insurance company, the reinsurer, acts as an insurer of another insurance company; typically, the reinsured insurance company pays a premium to the reinsurer and the reinsurer assumes a portion of the liabilities of the reinsured

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