# *Reserve Mechanical* and *Syzygy*: Income From Nothing

by James R. Browne

James R. Browne is a partner with Barnes & Thornburg LLP.

In this article, Browne argues that the Tax Court in *Reserve Mechanical* and *Syzygy* erred in holding that the taxpayers recognized taxable income on the receipt of insurance premiums received under arrangements that failed to qualify as true insurance for tax purposes.

Copyright 2019 James R. Browne. All rights reserved.

In two recent opinions,[1] the Tax Court held that a purported captive insurance arrangement was not a valid insurance arrangement, but went on to conclude that the premiums paid under the insurance policies were nevertheless taxable income to the insurance company.[2] In each case, the court justified its conclusion by summarily finding that the petitioner failed to present any evidence that the premium payments were not income to the insurance company.

The battle over the primary issue — whether the insurance arrangements were true insurance for tax purposes — will likely rage on, and this article offers no comment on that dispute in either case. Rather, I focus on the Tax Court's conclusions regarding taxable income in each case.[3] For the reasons discussed, I assert that to the extent the opinions are affirmed on the primary issue of true insurance, the Tax Court's rulings on the taxable income issue were incorrect. The Tax Court should have held that the premium payments received by the insurance companies, if not respected as premium income, constituted nontaxable contributions to capital.[4]

## I. The Cases

Before proceeding to a critique of the Tax Court's analysis and conclusions on the issue of taxable income, it is helpful to have a general understanding of the factual background of *Reserve Mechanical* and *Syzygy* and the court's disposition of the cases.

### A. *Reserve Mechanical*

*Reserve Mechanical* addresses the tax liability of an Anguilla insurance company (Reserve) that elected to be classified as a U.S. corporation under section 953(d)[5] and filed U.S. tax returns as a tax-exempt company under section 501(c)(15).[6] Reserve's ultimate shareholders were also the owners of three U.S. operating companies that purchased the only insurance policies issued by Reserve. Reserve transferred a portion of the risk

---

[1] *Reserve Mechanical Corp. v. Commissioner*, T.C. Memo. 2018-86; and *Syzygy Insurance Co. Inc. v. Commissioner*, T.C. Memo. 2019-34.

[2] I use "premium payments," "insurance policies," "insurance company," and similar terms based on the nominal characterization of those items by the taxpayers. No inference should be drawn regarding the proper treatment of those items for federal income tax purposes.

[3] In addition to deciding whether there was true insurance and taxable income, the Tax Court in *Syzygy* also concluded that the taxpayer was not subject to an accuracy-related penalty. This article also does not address the penalty issue. An issue that was not before the Tax Court in *Syzygy* is whether the premium payments constituted disguised taxable gifts by the operating company shareholders to the beneficiaries of the trusts that owned the insurance company. *See* reg. section 25.2511-1(h)(1). This article does not address the gift tax implications of the Syzygy insurance arrangements.

[4] Based on my analysis, it is difficult to understand why the commissioner is even pursuing the issue. Does he have any rational basis for asserting that the nominal premium payments lacked a nontax business purpose but nevertheless constituted taxable income to the insurance company? No basis is asserted in any of the commissioner's briefs in the cases, and the IRS's interests are rarely served by taking positions that are expedient in the context of a single case but indefensible as a general proposition.

[5] Under section 953(d), a foreign insurance company that is a controlled foreign corporation and that would qualify as an insurance company under subchapter L if it were a domestic corporation may make an election to be treated as a domestic corporation for federal income tax purposes.

[6] For the years at issue (2008-2010), an insurance company qualified for exemption under section 501(c)(15) if it was not a life insurance company and if (1) its gross receipts for the tax year did not exceed $600,000, and (2) more than 50 percent of its receipts consisted of premiums.



© 2019 Tax Analysts. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.

For more *Tax Notes* content, please visit www.taxnotes.com.

© 2019 Tax Analysts. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.

under its direct written policies to a reinsurance company (PoolRe) under stop-loss arrangements,[7] and then entered into a quota share arrangement with PoolRe to reinsure a specified portion of PoolRe's risks under a pool of reinsurance policies. In this manner, Reserve sought to achieve risk distribution regarding its direct written policies (that is, insurance of a large number of unrelated, third-party risks). Risk distribution is an essential element of being respected as a true insurance company for tax purposes.[8]

The commissioner determined that Reserve did not qualify as an insurance company eligible to elect to be classified as a U.S. corporation, or to be classified as a tax-exempt insurance company, because the insurance arrangements it entered into with its affiliates and PoolRe had no significant nontax purpose, lacked economic substance, and did not qualify as insurance for tax purposes.[9] The commissioner further determined that the amounts Reserve reported as premium income under those arrangements constituted non-insurance taxable income subject to a 30 percent withholding tax under section 881(a).[10]

At trial, the parties submitted extensive evidence regarding whether the insurance and reinsurance arrangements had economic substance and constituted true insurance for tax purposes. On that issue (which is beyond the scope of this article), the Tax Court held for the commissioner, finding that Reserve's transactions were not bona fide insurance transactions and, importantly, had no legitimate nontax business purpose.

The Tax Court then turned to whether the payments received by Reserve constituted income of a character subject to withholding tax under section 881(a). On this issue, neither party presented any separate evidence. The IRS argued in its post-trial brief that the premium payments constituted taxable income because Reserve reported the payments as income on its original tax returns and was bound by that characterization absent strong proof supporting an alternative characterization.[11] Reserve countered that the premium payments, if not true insurance premiums, were logically either capital contributions or nontaxable advances or deposits, and not income for tax purposes. As support for its position, Reserve cited Rev. Rul. 2005-40,[12] in which the IRS ruled that premiums paid under an arrangement that is not respected as an insurance contract for tax purposes "may instead be characterized as a deposit arrangement, a loan, a 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 arrangement between the parties."

On the taxable income issue, the Tax Court also held for the commissioner, primarily because Reserve failed to meet its burden of proof:

> Reserve bears the burden of showing that the income it received is not [fixed or determinable annual or periodic] income as respondent determined in the notice. See Rule 142(a). Reserve did not produce evidence which showed that the amounts at issue are not FDAP income subject to the 30 percent tax. We reject Reserve's contention that the amounts it received during the tax years in issue were capital contributions or nontaxable deposits.
>
> The record does not reflect that the parties to the purported insurance transactions treated or intended the amounts paid to Reserve as additional capital contributions. . . . Reserve failed to specify why the payments might otherwise be treated as nontaxable deposits.[13]

---

[7] Under the stop-loss arrangements, the reinsurance company insured against a specified amount of losses over a specified threshold amount.

[8] As noted by the Tax Court in its opinion, "Courts have looked to four criteria in deciding whether an arrangement constitutes insurance: (1) the arrangement involves insurable risks; (2) the arrangement shifts the risk of loss to the insurer; (3) the insurer distributes the risk among its policy holders; and (4) the arrangement is insurance in the commonly accepted sense." *Reserve Mechanical*, T.C. Memo. 2018-86, at 33.

[9] Respondent's Simultaneous Opening Brief at 44-48, *Reserve Mechanical*, T.C. Memo. 2018-86.

[10] *Id*. Section 881(a) imposes a 30 percent withholding tax on some "fixed or determinable annual or periodical gains, profits, or income" of a foreign corporation to the extent the income is from sources within the United States and is not effectively connected with the conduct of a trade or business within the United States.

[11] Answering Brief for Respondent at 67, *Reserve Mechanical*, T.C. Memo. 2018-86.

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

[13] *Reserve Mechanical*, T.C. Memo. 2018-86, at 64.



For more *Tax Notes* content, please visit www.taxnotes.com.

© 2019 Tax Analysts. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.

### B. *Syzygy*

Whereas *Reserve Mechanical* addressed the tax consequences of a captive insurance arrangement only from the perspective of the captive insurance company, *Syzygy* addressed the tax consequences of a captive insurance arrangement from the perspective of the insured parties, their owners, and the captive insurance company.

Under the insurance program in *Syzygy*, the operating companies (collectively, HT&A), all of which were S corporations beneficially owned by two principals and trusts for their families, generally purchased direct insurance policies from fronting carriers who then reinsured the first layer of risks to a Delaware insurance company (Syzygy) beneficially owned by trusts for the benefit of the families of the HT&A principals. The fronting carriers also entered a quota share arrangement with Syzygy, under which Syzygy agreed to reinsure a specified share of a pool of risks retained by the fronting carriers under the reinsurance arrangements with Syzygy and under similar reinsurance arrangements with other captive insurance companies. As in *Reserve Mechanical*, Syzygy sought to use the quota share arrangement to achieve risk distribution.

The operating companies treated the premium payments they made to the fronting carriers as true insurance premiums and claimed a deduction for the payments on their respective S corporation tax returns. Those deductions flowed through to the shareholders of the operating companies. Likewise, Syzygy reported the reinsurance premiums and quota share premiums received from the fronting carriers as insurance premium income for tax purposes. Syzygy elected to be classified as a small insurance company under section 831(b) and paid no tax on the premiums received.[14]

The commissioner determined that Syzygy did not engage in insurance transactions and was not an insurance company eligible to elect the benefits of section 831(b), and therefore Syzygy was liable for tax on its premium income.[15] As to the HT&A owners, the commissioner determined that: (1) the arrangements with the fronting carriers were invalid for lack of economic substance and lack of a nontax business purpose; (2) the premium payments were not payments for insurance; and (3) the amounts deducted were not ordinary and necessary business expenses.[16]

On the true insurance question, the Tax Court concluded that Syzygy did not qualify as an insurance company for tax purposes, and was therefore not eligible to elect the benefits of section 831(b), because: (1) the fronting carriers were not bona fide insurance companies and did not issue true insurance policies, and as a result Syzygy did not accomplish sufficient risk distribution; and (2) in the alternative, the arrangements and transactions among HT&A, the fronting carriers, and Syzygy were not insurance in the commonly accepted sense (primarily because of unreasonable premiums and late-issued policies). The Tax Court likewise held that the payments by the operating companies were not deductible as insurance premiums, as payments for indemnification contracts (because there was no intent to seek indemnification for covered losses under the policies), or otherwise as ordinary and necessary business expenses. The Tax Court did not address the commissioner's economic substance arguments.[17]

Syzygy argued that if the premium payments were received under arrangements that lacked economic substance and were not properly characterized as deductible payments by the operating companies, the premium payments should not be taxable to Syzygy. Syzygy also noted that none of the alternative characterizations cited in Rev. Rul. 2005-40[18] would give rise to disallowance of a deduction to the insured and simultaneous income to the insurance company.[19] The Tax Court summarily

[14] For the years at issue (2009-2011), section 831(b) provided that an insurance company with net written premiums (or, if greater, direct written premiums) of not more than $1.2 million for the year could elect to be taxed only on its investment income (and not on its underwriting income).

[15] Opening Brief for Respondent at 118-119, *Syzygy*, T.C. Memo. 2019-34, at 45.

[16] *Id*. at 78-79, 119-129; *Syzygy*, T.C. Memo. 2019-34, at 25.

[17] *Syzygy*, T.C. Memo. 2019-34, at 45.

[18] *See supra* note 12.

[19] Opening Brief for Petitioners at 57-58, *Syzygy*, T.C. Memo. 2019-34.



For more *Tax Notes* content, please visit www.taxnotes.com.

© 2019 Tax Analysts. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.

rejected this argument, again based on an alleged failure of proof:

> While the revenue rulings suggest the possibility that an arrangement that purports to be an insurance contract may instead be characterized as a deposit arrangement, a loan, a contribution to capital, or otherwise, there is no evidence that any such recharacterization is appropriate. See *Reserve Mech. Corp. v. Commissioner*, at *65-*66.[20]

## II. A Question of Law

The primary error in the Tax Court's analysis of the taxable income issue in *Reserve Mechanical* and *Syzygy* is that the question whether a payment constitutes income is a question of law, not a question of fact. In *Glenshaw Glass Co.*,[21] the Supreme Court characterized the issue of whether punitive damages awards received in private antitrust actions are within the definition of income for tax purposes as "one of statutory construction: are these payments comprehended by section 22(a)?"[22] An earlier Supreme Court decision was more direct on the nature of the inquiry, characterizing a Tax Court determination that embezzled money constituted taxable income to the embezzler as a "clear-cut mistake of law."[23]

While the concept of income in section 61 is very broad, it is not unlimited. Various exclusions are listed in sections 101 through 140, including section 118(a), which states, "In the case of a corporation, gross income does not include any contribution to the capital of the taxpayer." If the question of whether a payment received constitutes taxable income is a question of law, then it follows that it is also a question of law whether the payment is excluded from income as a contribution to capital.

The courts have developed a two-pronged test for answering this legal question when one corporation makes a nominally taxable payment to another commonly controlled corporation (as was the case in both *Reserve Mechanical* and *Syzygy*). Under this test, the payment is properly recharacterized as a deemed dividend and capital contribution to the extent that: (1) the common shareholder is able to exercise control over the payment through control of the payee corporation; and (2) the payment primarily benefited the common shareholder and the payer corporation obtained no substantial nontax business benefit from the payment.[24] In *Gulf Oil*,[25] the Tax Court and the Ninth Circuit applied this test in circumstances similar to those in *Reserve Mechanical* and *Syzygy*. Gulf Oil Corp. formed an insurance subsidiary, InsCo, and had it insure specified risks of Gulf and its operating subsidiaries. The courts determined that those arrangements were not true insurance for tax purposes.[26] The commissioner contended that the premium payments must be recharacterized as constructive dividends by the operating companies to Gulf and constructive capital contributions by Gulf to InsCo. The courts rejected this position, finding that the arrangement, although not qualifying as true

[20] *Syzygy*, T.C. Memo. 2019-34, at 48.

[21] *Commissioner v. Glenshaw Glass Co.*, 348 U.S. 426 (1955).

[22] *Id*. at 429. Section 22(a) of the 1939 Internal Revenue Code of 1939 became, without substantive change, section 61(a) of the IRCs of 1954 and 1986. *Cf. id*. at notes 9-11.

[23] *Commissioner v. Wilcox*, 327 U.S. 404, 407 (1946). Although *Wilcox* was limited to its facts by *Rutkin v. United States*, 343 U.S. 130 (1952), and was later overruled by *James v. United States*, 366 U.S. 213 (1961), the proposition that the determination of income is a question of law was approved in *Rutkin* and implicitly approved in *James*. *Rutkin*, 343 U.S. at 135 ("It remains for us to determine the legal issue whether money obtained by extortion is taxable to the extortioner under section 22(a)."); and *James*, 366 U.S. at 214 ("The facts are not in dispute."). *See also Maines v. Commissioner*, 144 T.C. 123, 128 (2015) (whether excess refundable state credits are taxable income under federal law is a "purely legal question").

[24] *Sammons v. Commissioner*, 472 F.2d 449 (5th Cir. 1972) (payment primarily for shareholder benefit treated as disguised dividend); *Worcester v. Commissioner*, 370 F.2d 713 (1st Cir. 1966) (payments between commonly controlled corporations allegedly for services, although none were rendered, constituted a deemed dividend to the common owner); *Knipe v. Commissioner*, T.C. Memo. 1965-131, *aff'd per curiam sub nom. Equitable Publishing Co. v. Commissioner*, 356 F.2d 514 (3d Cir. 1966) (participation payments were not paid for "any discernible consideration" or for "any proper corporate purpose" and therefore were treated as disguised dividends); and *Gilbert v. Commissioner*, 74 T.C. 60 (1980) (corporation's payment to a commonly controlled corporation that did not create any valid indebtedness and had no substantial corporate purpose to the payer corporation treated as a disguised dividend). *See also* Notice 2004-8, 2004-4 IRB 333 (payments exceeding an arm's-length consideration between commonly controlled corporations may be treated as disguised dividends by the payer corporation to the common owner and contributions by the owner to the payee corporation).

[25] *Gulf Oil Corp. v. Commissioner*, 914 F.2d 396 (1990), *aff'g* 89 T.C. 1010 (1987).

[26] The fatal flaw in Gulf's insurance arrangement was that Gulf indemnified the fronting carriers against losses incurred if InsCo failed to pay claims, with the result that Gulf had not shifted the risks of its operating subsidiaries to InsCo. *Gulf Oil*, 914 F.2d at 412 ("because of the guarantee to the primary insurers, Gulf and InsCo did not truly transfer the risk").



For more *Tax Notes* content, please visit www.taxnotes.com.

© 2019 Tax Analysts. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.

insurance, nevertheless served a substantial nontax business purpose of the premium-paying companies (that is, loss protection), and that the premium payments constituted an arm's-length consideration for payments of claims by InsCo.

In summary, whether the premium payments in *Reserve Mechanical* and *Syzygy* constituted taxable income or a nontaxable contribution to capital was a legal question, and that question should have been resolved based on a factual determination under the two-pronged test applied by numerous prior cases.[27]

The Tax Court in *Reserve Mechanical* and *Syzygy* erred in failing to articulate the applicable legal test and in failing to make any findings of fact consistent with that test. In *Reserve Mechanical*, the court declared, without any analysis at all, that the premium payments were income.[28] It then concluded that Reserve had not met its burden of producing evidence to counter that characterization.[29] Under the correct legal test, the insurance company's burden was not to establish that the payments did not constitute income. Rather, its burden was to establish whether (1) the common owners controlled the insurance company (a fact that was established on the record and not in dispute), and (2) the operating companies obtained no substantial nontax business benefit for the payments (a fact that the insurance company disavowed, but which the Tax Court specifically found).[30]

In *Syzygy*, the Tax Court appeared to commit a similar error, although its discussion of the issue is so cryptic that it is difficult to discern the basis for the court's ruling. The court summarily concluded that "there is no evidence" to support any characterization other than taxable income, and cited *Reserve Mechanical* in support of its conclusion.[31] The implication is that the *Syzygy* court also approached the issue as one of fact that could be dismissed based on a failure of proof, and not an issue of law to be decided according to the relevant legal test and the facts in evidence.

Assuming the respective appellate courts[32] correctly determine that whether the premium payments constitute taxable income is a question of law to be reviewed by the appellate court *de novo*,[33] a strong argument can be made that the facts of record in each case are sufficient to reverse the Tax Court opinions and hold that the payments constituted nontaxable capital contributions. Alternatively, the appellate court might instead simply articulate the proper legal test and remand the case to the Tax Court for further findings consistent with that test. Even if the issue is remanded to the Tax Court, it is difficult to conceive how the commissioner could prevail on the issue.

### III. Presumption of Correctness?

A possible second error in the Tax Court's analysis of the taxable income issue was assigning a presumption of correctness to the commissioner's deficiency notice. If, as I argue, the notice of deficiency was not entitled to a presumption of correctness, the Tax Court should have ruled for the insurance company (regardless of whether the matter was a question or law or a question of fact).

As correctly noted in both *Reserve Mechanical* and *Syzygy*, the commissioner's determinations in a notice of deficiency are generally entitled to a

---

[27] *Cf. id*. at 413 ("The Commissioner provides no strong reason, support or authority to compel us to overturn either the Tax Court's factual determination of an adequate business reason for the transfer or the legal conclusion that the payments in question do not constitute constructive dividends to Gulf.").

[28] "Reserve bears the burden of showing that *the income it received* is not FDAP income." *Reserve Mechanical*, T.C. Memo. 2018-86, at 64 (emphasis added).

[29] The Tax Court observed that there was no evidence that the parties "treated or intended" the payments as capital contributions. *Reserve Mechanical*, T.C. Memo. 2018-86, at 65. The absence of such evidence is irrelevant in determining whether the payments constituted contributions to capital. *See supra* note 24. *Cf.* Rev. Rul. 93-16, 1993-1 C.B. 26 (approving the five-factor test set forth in *United States v. Chicago, Burlington & Quincy Railroad Co.*, 412 U.S. 401, 432 (1973), for determining whether nonshareholder payments are properly characterized as contributions to capital; none of the factors include the "treatment or intent" of the payments as relevant considerations). Moreover, the absence of such evidence is unsurprising given that Reserve's primary position was that the payments constituted insurance premiums and not capital contributions.

[30] *Reserve Mechanical*, T.C. Memo. 2018-86, at 62 ("there was no legitimate business purpose for the policies that Reserve issued for the insureds").

[31] *Syzygy*, T.C. Memo. 2019-34, at 48.

[32] *Reserve Mechanical* is on appeal to the Tenth Circuit. An appeal in *Syzygy* would be taken to the Third Circuit.

[33] *Pierce v. Underwood*, 487 U.S. 552, 558 (1988); *Kelley v. Commissioner*, 45 F.3d 348, 350 (9th Cir. 1995).



For more *Tax Notes* content, please visit www.taxnotes.com.

presumption of correctness and the taxpayer bears the burden of proving that the determinations are incorrect.[34] The presumption of correctness is merely a procedural device that makes clear that the taxpayer has the initial burden of providing sufficient evidence to support a finding that the commissioner's determination as set forth in the notice of deficiency is incorrect (that is, the burden of going forward, also referred to as the burden of production). If the taxpayer fails to meet this initial burden, the commissioner's determination prevails. But if the taxpayer meets its initial burden of production, the presumption of correctness falls away, and the commissioner bears the burden of producing credible and admissible evidence to counter the taxpayer's evidence. The taxpayer retains the ultimate burden of proving the merits of its position by at least a preponderance of the evidence (that is, the burden of persuasion).[35]

In cases considering whether the taxpayer has unreported income, the presumption of correctness puts the taxpayer in the difficult position of having to prove a negative: that it didn't receive the alleged unreported income. To remedy this inequity, the courts have generally held that the commissioner must produce some "predicate evidence" for the deficiency determination and cannot rely on a "naked assessment" having no credible evidentiary foundation. In the absence of such predicate evidence, a decision is entered for the taxpayer.[36]

The cases supporting this approach generally involve situations in which there is uncertainty regarding whether the taxpayer actually received the alleged income items or whether the taxpayer received the amounts determined by the commissioner. In *Reserve Mechanical* and *Syzygy*, there was no dispute that the insurance company received premium payments, nor was there any dispute regarding the amount of those payments. Rather, the dispute was whether those payments constituted income. Despite this distinction, both *Reserve Mechanical* and *Syzygy* involve a determination by the commissioner that the insurance company had unreported income, and the Tax Court forced the insurance company to prove that the payments were not income. The equitable case for requiring the commissioner to produce some evidence in support of the notice of deficiency is particularly strong in *Reserve Mechanical* and *Syzygy*, considering that the commissioner's determination in each case is inconsistent with its assertion that the transactions lacked economic substance and business purpose, and considering that the IRS cited no relevant facts and provided no rational analysis for its assertion that the payments constituted taxable income.[37]

To the extent the Tax Court held that there was truly no evidence regarding whether the premium payments received by Reserve and

[34]Tax Court Rules of Practice and Procedure, Rule 142(a) (2018); *Welch v. Helvering*, 290 U.S. 111, 115 (1933). *See also Greenberg's Express Inc. v. Commissioner*, 62 T.C. 324, 328 (1974) ("The underlying rationale for the foregoing is the fact that a trial before the Tax Court is a proceeding de novo; our determination as to a petitioner's tax liability must be based on the merits of the case and not any previous record developed at the administrative level.").

[35]*See Rockwell v. Commissioner*, 512 F.2d 882 (9th Cir. 1975); and *Gilford v. Commissioner*, 88 T.C. 38 (1987).

[36]*See United States v. Janis*, 428 U.S. 433, 441 (1976) (determination of unreported drug trafficking income based on illegally obtained evidence not entitled to a presumption of correctness); *Portillo v. Commissioner*, 932 F.2d 1128, 1133 (5th Cir. 1991), *subsequent proceedings*, 988 F.2d 27, 29 (5th Cir. 1993) (reliance on a Form 1099 alone was not sufficient to establish that the taxpayer had unreported income without evidence of actual payment or receipt); *Anastasato v. Commissioner*, 794 F.2d 884 (3d Cir. 1986) (unreported travel commission kickbacks); *Weimerskirch v. Commissioner*, 596 F.2d 358 (9th Cir. 1979) (unreported income from business of selling heroin); *United States v. Rexach*, 896 F.2d 710 (2d Cir. 1990) (unreported income from construction contracts); *Senter v. Commissioner*, T.C. Memo. 1995-311 (no tax returns filed; estimate of unreported income based on a prior year's income not sufficient to support a presumption of correctness); and *McManus v. Commissioner*, T.C. Memo. 2006-57 (unreported nonemployee compensation; unconvincing testimony of agent based on a review of the administrative file was not sufficient when file was not introduced into evidence).

[37]The commissioner's argument that Reserve reported the premium payments as income and is bound by that reporting is insufficient to sustain the notice of deficiency. The commissioner cannot argue that the reported tax treatment was improper and must be disregarded for tax purposes, and also simultaneously argue that the reported tax treatment was binding on the taxpayer.



For more *Tax Notes* content, please visit www.taxnotes.com.

© 2019 Tax Analysts. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.

© 2019 Tax Analysts. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.

Syzygy constituted income, the commissioner's notice of deficiency was a mere naked assessment having no evidentiary foundation, and the Tax Court should have concluded that the commissioner's determination was not entitled to a presumption of correctness. The commissioner should have had the burden of presenting some evidence sufficient to establish that the premium payments constituted income, so that the insurance companies could have known to what evidence and legal theories they needed to respond. If there was no evidence to support the commissioner's determination, the court should have ruled for the insurance companies.

In fairness, it is not clear from either opinion whether the Tax Court concluded that there was *no evidence at all* on the taxable income issue, or if it determined instead that there was evidence, just none supporting the taxpayer's position. For example, the court might have concluded that the uncontested fact that the insurance company received a payment of a stipulated amount from the operating company was sufficient predicate evidence to support the commissioner's determination that the insurance company recognized income and to sustain the presumption of correctness normally attaching to the commissioner's notice of deficiency. If that was the court's analysis, it certainly did a good job of hiding it.

## IV. Abundant Evidence

The third and most glaring error in the Tax Court's analysis of the taxable income issue is the court's disregard for the extensive evidentiary record presented in each case. The record that the court recited in great detail to support its conclusion that the arrangement was not insurance for tax purposes was more than sufficient to support a conclusion that the payments were not income to the insurance company.

The most direct evidence supporting the positions of the insurance companies that the premium payments were not taxable income is the commissioner's assertion in each case that the insurance arrangements had no nontax business purpose and lacked economic substance.[38] A finding that an arrangement lacks economic substance is sometimes regarded as causing the transaction to be disregarded for tax purposes.[39] If the insurance transactions are disregarded, the transactions arguably cannot give rise to taxable income to the insurance company.[40]

In dealing with transactions lacking economic substance, some courts will disregard the reported tax consequences while still recognizing that the underlying transactions (that is, flows of funds) in fact took place and giving tax effect to those transactions based on the residual economic effects of the transactions.[41] In *Reserve Mechanical* and *Syzygy*, the court went to great lengths to point out, based on an extensive factual record, that the operating company received no substantive benefit for the alleged premium payments. The Tax Court found as a fact that the operating company transferred funds to the insurance company and effectively got nothing in return.[42] On those facts, the only rational characterization of the premium payments is disguised dividends by the operating company to its shareholders followed by contributions to capital by the shareholders to the insurance company. There is no other explanation that makes any sense, and the commissioner certainly cited no evidence or explanation that would justify classifying the payments as income.

Considering the Tax Court's extensive factual findings in these cases, and considering the

---

[38] *Supra* note 9, at 16.

[39] *Lerman v. Commissioner*, 939 F.2d 44, 45 (3d Cir. 1991) ("If a transaction is devoid of economic substance . . . it simply is not recognized for federal taxation purposes, for better or for worse.").

[40] *See Arrowhead Mountain Getaway Ltd. v. Commissioner*, T.C. Memo. 1995-54, at 70 ("From the fact that the transactions between the Partnership and the limited partners were shams, it follows that the Partnership received no taxable income from such transactions."), *aff'd*, 119 F.3d 5 (9th Cir. 1997); and *Seykota v. Commissioner*, T.C. Memo. 1991-541, at 10 (the "transactions lacked economic substance. . . . We must therefore give effect neither to the income nor to the deductions generated by that program").

[41] *Rice's Toyota World Inc. v. Commissioner*, 752 F.2d 89, 95 (4th Cir. 1985) ("Where a transaction is properly determined to be a sham, the Commissioner is entitled to ignore the labels applied by the parties and tax the transaction according to its substance.").

[42] *Reserve Mechanical*, T.C. Memo. 2018-86, at 62 ("there was no legitimate business purpose for the policies that Reserve issued for the insureds"); *Syzygy*, T.C. Memo. 2019-34, at 38 ("HT&A did not submit a single claim" even though there were claims eligible for coverage).



For more *Tax Notes* content, please visit www.taxnotes.com.

commissioner's assertion that the transactions lacked a nontax business purpose and economic substance, it is difficult to see how the court could have concluded that the insurance companies presented no evidence to support their positions that the disallowed premium payments constituted nontaxable capital contributions.

## V. Conclusion

In *Reserve Mechanical* and *Syzygy*, the Tax Court erroneously treated the question of whether the insurance companies recognized taxable income as a question of fact. This error caused the court to misstate the insurance companies' burden of proof and neglect the proper legal analysis. The court demanded that the insurance companies prove that the premium payments they received were not income, and summarily concluded that they had failed to meet this burden on the ground that there was no evidence on that question. The court should have instead evaluated whether there were sufficient facts in evidence to support a prima facie case that the payments satisfied the well-established two-pronged test for treatment as nontaxable contributions to capital. It also should have evaluated whether there was other evidence establishing some contrary characterization consistent with the commissioner's treatment of the premiums as taxable income (taking into account the commissioner's assertion that the payments lacked economic substance and served no nontax business purpose).

Regardless of the characterization of the issue as one of fact or one of law, if there was truly no evidence at all on the character of the payments as income, the Tax Court should have ruled for of the insurance companies, on the theory that liability for unreported income cannot rest on a naked assessment lacking any evidentiary foundation.

Finally, even if the Tax Court was correct in ascribing the normal presumption of correctness to the commissioner's determination regarding the taxable income issue (despite the notice of deficiency being internally inconsistent and without any evidentiary foundation on that issue), the Tax Court inexplicably ignored the abundant contrary evidence in the record. That evidence easily established facts sufficient to support the position of the insurance companies that if the premium payments were not paid in connection with true insurance arrangements, those payments necessarily constituted nontaxable contributions to capital and not taxable income.

Stated more succinctly, these cases represent a failure of analysis, not a failure of proof. ■

© 2019 Tax Analysts. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.



For more *Tax Notes* content, please visit www.taxnotes.com.