

US TAX COURT
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US TAX COURT
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JUL 30 2016

JAMES L. WILSON & VIVIEN WILSON, ET AL.
Petitioner(s)

ELECTRONICALLY FILED

v.

Docket No. 26547-13,
15011-14,

26548-13,
16759-14

COMMISSIONER OF INTERNAL REVENUE,
Respondent

PRETRIAL MEMORANDUM

SERVED Jul 30 2016

UNITED STATES TAX COURT

JAMES L. WILSON & VIVIEN WILSON, ET	)	
AL.,	)	
Petitioners,	)	
	)	
v.	)	Docket Nos. 26547-13, 26548-13,
	)	15011-14, 16759-14
COMMISSIONER OF INTERNAL REVENUE,	)	
	)	Filed Electronically
Respondent.	)	
	)	Trial Calendar
	)	Phoenix, AZ
	)	August 15, 2016

PRETRIAL MEMORANDUM FOR PETITIONERS

ATTORNEYS:

Petitioners: Kacie N.C. Dillon, Tel. (602) 532-9196
Tim A. Tarter, Tel. (602) 532-9197

Respondent: David W. Sorenson, Tel. (801) 799-6631
R. Craig Schneider, Tel. (801) 799-6624
Derek S. Pratt, Tel. (602) 636-9632
Brandon A. Keim, Tel. (602) 636-9627

AMOUNTS IN DISPUTE:

James L. Wilson and Vivien Wilson; Docket No. 26547-13

<u>Tax Year Ended</u>	<u>Deficiency in Tax</u>	<u>I.R.C. § 6662(a)</u> <u>Additions to Tax</u>
Dec. 31, 2009	\$57,596.00	\$11,510.00

ICA Health, LLC formerly known as Immunogenics Company of America; Docket No. 26548-13

<u>Tax Year Ended</u>	<u>Deficiency In Tax</u>	<u>I.R.C. § 6662(a) Additions to Tax</u>	<u>I.R.C. § 6651(a)(1) Additions to Tax</u>
Jan. 31, 2010	\$256,093.00	\$51,218.60	\$0
Jan. 31, 2011	\$233,083.00	\$46,616.60	\$59,825.50

Future Formulations, LLC; Docket No. 15011-14

<u>Tax Year Ended</u>	<u>Deficiency in Tax</u>	<u>I.R.C. § 6662(a) Additions to Tax</u>
Jan. 31, 2012	\$18,767.00	\$3,753.40 ¹

Dylaluha Dynast Trust, Tax Matter Partner of Mind Mine, LLC; Docket No. 16759-14

<u>Tax Year Ended Dec. 31, 2010</u>	
<u>Proposed Adjustments</u>	<u>Amount</u>
Captive Insurance Premiums	\$113,000.000
I.R.C. § 6662(a) Additions to Tax	

STATUS OF CASE:

Definite Trial.

CURRENT ESTIMATE OF TRIAL TIME:

The Court has ordered a special trial session commencing on August 15, 2016 in Phoenix, Arizona. Petitioners expect the trial will last 5 days (40-50 hours). Petitioners and respondent have agreed each side is entitled to a total of 20 hours (or half the

¹ Respondent raised on Answer for the first time, a penalty or addition to tax under I.R.C. § 6662(a). Accordingly, respondent bears the burden of proof.

allotted time) for their case in chief, cross examination and rebuttal.

MOTIONS YOU EXPECT TO MAKE:

On July 22, 2016, Petitioners filed two Motions in Limine: (1) Motion to Preclude Newly Raised Matters, and (2) Motion to Shift the Burden of Proof.

Petitioners may file additional Motions in Limine regarding respondent's expert witnesses by the Court-ordered deadline on August 8, 2016.

STATUS OF STIPULATION OF FACTS:

The parties are currently working on the Joint Stipulation of Facts, which will be filed on August 15, 2016.

ISSUES:

All Consolidated Cases (Docket Nos. 26547-13, 26548-13, 15011-14 and 16759-14)

a. Whether the insurance expenses were paid or incurred, and are ordinary and necessary businesses expenses in the taxable years?

b. Whether the payments made to Rifa Jace Insurance Company, Ltd. ("Rifa Jace Insurance"), were paid for insurance to an insurance company?

c. Whether the substance of the transactions between Wilson entities² and Rifa Jace Insurance comports with the form; whether

² "Wilson entities" includes Mind Mine, LLC, ICA Health, LLC and Future Formulations, LLC. Note, Mind Mine, LLC was a disregarded entity in 2009 and owned solely by petitioner James Wilson.

the transactions between Wilson entities and Rifa Jace Insurance were entered into solely for tax avoidance or evasion purposes; and whether the transactions between Wilson entities and Rifa Jace Insurance lack economic substance?

d. Whether Petitioners are liable for penalties or additions to tax pursuant to I.R.C. § 6662(a)?

Future Formulations, LLC v. Commissioner (Docket No. 15011-14)

e. Whether Petitioner is entitled to a net operating loss deduction carried forward from tax years ending January 31, 2010 and January 31, 2011?³

ICA Health, LLC formerly known as Immunogenic Company of America; Docket No. 26548-13

f. Whether Petitioner is liable for penalties or additions to tax pursuant to I.R.C. § 6651(a)(2) for tax year ending January 31, 2011.

WITNESS(ES) YOU EXPECT TO CALL:

Dr. James L. Wilson may be called to testify regarding all aspects of this case, including but not limited to, the businesses that purchased insurance from Rifa Jace Insurance and Pan American Reinsurance Company, Ltd. ("Pan American"), insurance decisions, risk management, loans from Rifa Jace, investment decisions and claims filed.

³ Respondent disallowed the portion of Future Formulations' net operating loss related to the insurance premiums paid to Rifa Jace during tax years ending January 31, 2010 and January 31, 2011. Accordingly, this issue is not separately analyzed.

Celia Clark, Attorney at Clark & Gentry, PLLC, may be called to testify regarding all aspects of this case, including but not limited to, the formation of Rifa Jace Insurance, corporate structure and management of Rifa Jace Insurance, insurance policies issued by Rifa Jace Insurance, reinsurance of risk by Rifa Jace Insurance, pooling of policies, the Wilson entities' business risks, Pan American, terrorism insurance, investments and loans, claims filing process and St. Kitts insurance regulations.

Richard Smith, Attorney at Jennings, Strouss & Salmon, PLC, or Kathleen Giancana, Attorney at O'hanlon, Skomal, Giancana & Arnold,⁴ may be called to testify regarding their introduction to the Wilsons and Celia Clark, the professional advice provided to Wilsons regarding the formation and taxation of Rifa Jace Insurance and the Wilson entities, their role in the formation of Rifa Jace Insurance and their involvement and advice regarding the loans from Rifa Jace Insurance.

Curtis Muhlenbruch, Heritor Management, Ltd., may be called to testify regarding Heritor Management's involvement with Rifa Jace Insurance and any dealings with the Financial Service Regulatory Commission, St. Kitts Branch generally, claims processed and loans made by Rifa Jace. Mr. Muhlenbruch may also testify regarding Heritage Management's involvement with Pan American and any dealings with the regulatory agencies in Nevis.

Allen Rosenbach, Actuary, ACR Solutions Group, may be called to testify regarding his experience as an actuary pricing insurance

⁴ In the event Mr. Smith is unable to travel to Phoenix for his testimony, Ms. Giancana may be called to testify in his place.

policies, his actuarial reports, and his pricing and premium determinations of the policies for the years at issue.

Dennis Wilson, may be called to testify regarding his dealings with Dr. Wilson and other entities regarding mortgage backed loans made.

Don Radokovich or Amy Chavez, Certified Public Accountant at R&A CPAs, may be called to testify that ICA Health, LLC, timely filed its income tax return for fiscal year ending January 31, 2011.⁵

Michael Angelina, ACAS, MAAA, CERA, may be called to provide the Court with expert and rebuttal expert testimony regarding Rifa Jace Insurance, including but not limited to an analysis of insurance risks, insurance policies and insured risks for the years at issue, capitalization and solvency, risk distribution, commonly accepted notions of insurance and actuarial analysis of the insurance coverages and premiums for each coverage.

Daniel Spragg, Managing Director of Alvarez & Marsal and National Practice Leader for Risk Management Advisory Division, may be called to provide the Court with expert and rebuttal testimony regarding Rifa Jace Insurance, including but not limited to an analysis of the captive insurance industry, insurance policies, risk shifting, risk distribution, insurable risks,

⁵ Petitioners have provided evidence to respondent that ICA Health's tax return for tax year ending January 31, 2011 was timely filed. Petitioners also sent respondent a proposed Stipulation of Settled Issues resolving the issue. If respondent agrees, these witnesses will not be called by Petitioners in their case in chief.

terrorism insurance, insurance regulation, underwriting, commonly accepted notions of insurance and permissible investments.

Sheila Small, Managing Director of Alvarez & Marsal's Insurance Advisory Service Group, may be called to provide the Court with expert and rebuttal testimony regarding Rifa Jace Insurance, including but not limited to an analysis of the captive insurance industry, insurance policies, risk shifting, risk distribution, insurable risks, terrorism insurance, insurance regulation, underwriting, commonly accepted notions of insurance and permissible investments.

Charles R. Cohen, Attorney at Charles R. Cohen, PLLC, may be called to provide the Court with expert and rebuttal testimony regarding insurance regulation, including Rifa Jace Insurance's compliance with St. Kitts and Arizona insurance regulations.

Petitioners reserve the right to call any and all witnesses respondent may call as a witness, as well as witnesses not disclosed here for purposes of rebuttal or impeachment testimony.

SUMMARY OF FACTS:

James L. and Vivien Wilson

James L. and Vivien Wilson are married taxpayers who reside in Arizona. James L. Wilson ("Dr. Wilson") has doctorates in Chiropractic Medicine and Naturopathic Medicine. Dr. Wilson also has a Ph.D. in Human Nutrition with minors in Immunology, Microbiology, Pharmacology and Toxicology, as well as research in Cellular Immunology.

While Dr. Wilson started his medical career as a chiropractor, he ultimately left bone setting and began a career in naturopathic

medicine. Dr. Wilson coined the term "adrenal fatigue," which he describes as a syndrome resulting when the adrenal glands function below the necessary level. Adrenal fatigue is associated with intense or prolonged stress, and can also arise after acute or chronic infections (especially respiratory), including influenza, bronchitis or pneumonia. Dr. Wilson authored a book titled "*Adrenal Fatigue: The 21st Century Stress Syndrome*." Over 400,000 copies of the book have been sold in six different countries. Dr. Wilson has authored several other professional publications, and is regularly invited to speak both nationally and internationally regarding adrenal fatigue and other topics.

Dr. Wilson formulated sixteen products focused on natural remedies.⁶ All products are branded "Dr. Wilson's Original Formulations." Dr. Wilson's Original Formulations are high-quality dietary supplements. These unique dietary supplements are designed to effectively target specific imbalance brought about by stress, inadequate nutrition, digestion issues, and diminished immune and endocrine function. These products include supplements for adrenal fatigue, digestive health, stress overdrive, blood sugar balance, immune health, tissue health and travel health. Dr. Wilson even formulated a supplement for children called Super Immune Space Sprinkles, which is a color changing powder that can be sprinkled into a beverage or food to enhance a child's immune

⁶ Dr. Wilson's Original Formulations includes 16 different products; however, because some products are sold in different quantities, the sales reports reflect 21 products sold.

system. Dr. Wilson's Original Formulations are sold throughout the United States, and worldwide in over 30 countries.

Not to be left out, Mrs. Wilson has been a dedicated mother to their four children, and Dr. Wilson's biggest support system. Mrs. Wilson is a brilliant writer who serves as Dr. Wilson's chief editor.

Petitioners' Businesses³

Mind Mine, LLC ('Mind Mine')

Mind Mine is a limited liability company that was formed in 2006. Originally, Mind Mine was a single member LLC and Dr. Wilson was the sole member. Accordingly, Mind Mine's income and expenses were reported on a Schedule C attached to Dr. and Mrs. Wilson's income tax returns. In 2010, Mind Mine was owned by Ambika, LLC, (49.5%), Broad Reach Financial (49.5%), and the Dylaluha Dynasty Trust (1%). Mind Mine is a calendar year taxpayer.

Mind Mine holds the rights to all of Dr. Wilson's Original Formulations brand. Mind Mine owns the formulas for all 16 products. Mind Mine also owns approximately 29 U.S. trademarks, (19 of which are registered in New Zealand and Australia); and approximately 160 URLs for the websites where the products are sold. Mind Mine earns revenues from the sale of Dr. Wilson's book, *Adrenal Fatigue: The 21st Century Stress Syndrome*, educational CDs and Dr. Wilson's speaking engagements. Commissions from the sale

³Petitioners own other businesses; however, this discussion is limited to the businesses that purchased insurance from Rifa Jace.

of *Adrenal Fatigue: The 21st Century Stress Syndrome* are paid to the publisher of the book, Smart Publications.

ICA Health, LLC formally known as Immunogenics Company of America ("ICA")

ICA is a limited liability company that was incorporated in 2006. ICA elected to be classified as an association taxable as a corporation for federal income tax purposes. ICA is a fiscal year taxpayer with its fiscal year ending January 31. Dr. Wilson is the sole shareholder of ICA.

ICA is a wholesale distributor of Dr. Wilson's Original Formulations brand to physicians, pharmacies and medical practices throughout the United States and some foreign countries. ICA also sells *Adrenal Fatigue: The 21st Century Stress Syndrome*. ICA's sales occur online or over the phone. ICA pays royalties to Mind Mine for the right to manufacture, advertise, promote and distribute Dr. Wilson's Original Formulations brand. ICA also pays commissions on all book sales to Smart Publications.

ICA's business operations are in Tucson, Arizona. ICA has an office and warehouse located in Tucson. ICA contracts with third party manufactures for all products. When ICA receives products from manufactures it tests, processes and labels the products before they are shipped. ICA leases computers, servers and other equipment from Lyndon Lease, LLC. Pursuant to the lease, ICA is responsible for maintaining and repairing or replacing the equipment.

Future Formulations, LLC ("Future Formulations")

Future Formulations is a limited liability company that was incorporated on March 22, 2006. Future Formulations is owned by

Mingo, LLP⁷ (50%), and Capener Capital, LLC⁸ (50%). Future Formulations has elected to be classified as an association taxable as a corporation for federal income tax purposes. Future Formulations is a fiscal year taxpayer with its fiscal year ending January 31.

Future Formulations is a retail sales company that sells Dr. Wilson's Original Formulations to the public online. Future Formulations purchases all products for resale from ICA.

During 2009 through 2011, Future Formulations had 14-15 employees. Future Formulations business operations are in Tucson, Arizona. Future Formulations leases computers, servers and other equipment from Lyndon Lease, LLC. Pursuant to the lease, Future Formulations is responsible for maintaining and repairing or replacing the equipment.

Petitioners' Business Risk Management

From inception of the businesses, petitioners always engaged in enterprise risk management. Petitioners formed separate businesses, each performing separate business functions. Dr. and Mrs. Wilson have used limited liability companies, trusts, and other planning tools to limit their personal exposure to law suits and other risks of loss. Prior to 2006, Mind Mine, ICA and Future Formulations did not purchase any property/casualty insurance.

⁷ Originally, Mingo, LLP was owned 98% by Dylaluha Dynasty Trust, 1% Dr. Wilson and 1% Mrs. Wilson. In 2010, after a restructuring, Mingo was owned by 49% Broach Reach, LLC, and 1% Dr. Wilson and 1% Mrs. Wilson.

⁸ Capener Capital, LLC is managed by Dylan Capener (Wilsons' son) and owned by Kaia Capener (Wilsons' granddaughter).

When business started to ramp up, Dr. Wilson realized the entities needed insurance because each entity had significant uninsured exposure to risk.

After grousing to his long-time CPA, Judy Johnson, of his worries about the litigious nature of the dietary supplement industry and his quickly growing uninsured companies. Ms. Johnson suggested Dr. Wilson contact Richard Smith ("Mr. Smith") to inquire about Captive Insurance. Mr. Smith had previously done legal work for Dr. Wilson in the past and Dr. Wilson was confident in Mr. Smith's work and advice. Eventually, Dr. Wilson scheduled an appointment with Mr. Smith to discuss captive insurance and other legal matters, including updating his estate plan.

Rifa Jace Insurance Company, Ltd.

Dr. Wilson eventually hired Mr. Smith to determine whether a Captive Insurance Company was a feasible option for his perceived insurance needs. Mr. Smith hired The Law Office of Celia Clark ("Clark")⁹ to assist his firm in determining feasibility of an insurance company and eventually forming Rifa Jace Insurance Company, Ltd. ("Rifa Jace Insurance"). In the beginning, Dr. Wilson was unaware Mr. Smith hired Clark to assist with his matter.

In 2007, Petitioners, through Clark and Smith formed Rifa Jace Insurance. Once Rifa Jace Insurance was formed, Clark was retained to provide maintenance services for Rifa Jace Insurance. Rifa Jace Insurance is a "captive insurance company" as defined

⁹ References to "Clark" include Law Offices of Celia Clark, Clark & Gentry, P.C., and Celia Clark, interchangeably.

by the U.S. Tax Court.⁵ Rifa Jace Insurance submitted the requisite filings to incorporate in Saint Christopher and Nevis ("St. Kitts"). Rifa Jace Insurance also obtained a certificate of authorization to conduct a small group captive insurance business. Rifa Jace Insurance has held a valid certificate of authorization to conduct a small group captive insurance business from 2007 through the current year. Rifa Jace Insurance is regulated by St. Kitts and its insurance certificate has never been suspended or revoked.

Rifa Jace Insurance maintained separate bank accounts and books and records. Rifa Jace Insurance timely filed all Treasury Forms 1120-PC, U.S. Property and Casualty Insurance Company Income Tax Return, since inception. Rifa Jace Insurance also maintains all corporate records, including annual meeting minutes.

Although Rifa Jace Insurance is a legal corporation in St. Kitts, it made an election under I.R.C. § 953(d) to be taxed as a domestic corporation in the United States. This election was approved by the Internal Revenue Service and has never been revoked. In addition, since inception Rifa Jace Insurance made a valid election to be taxed as a small insurance company under section 831(b) of the Internal Revenue Code. Rifa Jace Insurance's 831(b) election has also never been revoked.

⁵A captive insurance company is a corporation that handles all or part of the insurance needs of affiliated entities. *Harper Group and Includible Subsidiaries v. Commissioner*, 98 T.C. 4, n.3 (1994), *aff'd*, 979 F.2d 1341 (9th Cir. 1992).

Insurance Policies Underwritten by Rifa Jace Insurance¹⁰

Rifa Jace issued insurance policies beginning in 2007. The tax years before the Court include December 31, 2009, December 31, 2010, January 31, 2010 and January 31, 2011.

2009-2010 Tax Years

In 2009-2010, Rifa Jace Insurance wrote the following policies for the following entities:

Policy Period December 15, 2009 through December 15, 2010

Insured Entity	Insurance Policy	Premium	Limits Occurrence/Aggregate
Mind Mine	Litigation Expense	\$26,000	\$1,000,000/1,000,000
	Computer Operations	\$16,000	\$500,000/500,000
	Business Risk Indemnity	\$62,000	\$2,000,000/2,000,000
	Total	\$104,000	
ICA	Business Income & Extra Expense	\$162,000	\$2,000,000/2,000,000
	Computer Operations & Data	\$62,000	\$2,000,000/2,000,000
	Litigation Expense	\$90,000	\$2,000,000/2,000,000
	Tax Indemnity	\$75,000	\$2,000,000/2,000,000
	Total	\$389,000	
Future Formulations	None		

Policy Period January 31, 2010 through January 31, 2011

Insured Entity	Insurance Policy	Premium	Limits Occurrence/Aggregate
ICA	Products Liability	\$132,000	\$2,000,000/2,000,000
Future Formulations	Products Liability	\$31,000	\$500,000/1,000,000

The Litigation Expense policy generally covers losses resulting from legal proceedings instituted against the insured

¹⁰ The insurance policies referenced in this section are those that were deducted by Petitioners for the years at issue.

related to the business operations, among other legal matters. The Computer Operations and Data policies cover losses resulting from failures, breakdowns or malfunctions of computer and other equipment. The policies cover the expenses of replacing or repairing the property, and increased cost of working among, other potential losses.

The Business Risk Indemnity policy is a general business liability policy that covers the insured's liability to third parties. The Business Income and Extra Expense covers lost income (not exceeding overhead expenses) resulting from the entrance of a competitor providing replacement services in the insured marketplace, and uncollected accounts receivables. The Tax Indemnity policy covers losses resulting from an adverse determination of a taxing authority. This policy specifically excludes determinations regarding the taxability of the captive insurance expenses and fraudulent or criminal conduct, and willful violations of law, among other things.

Finally, the Products Liability policy insures against claims by third parties related to the sale of Dr. Wilson's Original Formulations products. The policy extends to errors and omissions of employees, costs for recalling products, and judgments, among other things.

2010-2011 Tax Years

For 2010-2011 Rifa Jace Insurance wrote the following policies for the following entities:

Policy Period December 15, 2010 through December 15, 2011

Insured Entity	Insurance Policy	Premium	Limits Occurrence/Aggregate
Mind Mine	Litigation Expense	\$33,000	\$1,000,000/1,000,000
	Computer Operations & Data	\$16,000	\$500,000/500,000
	Business Risk Indemnity	\$62,000	\$2,000,000/2,000,000
	Total	\$111,000	
ICA	Business Income & Extra Expense	\$171,000	\$1,000,000/2,000,000
	Computer Operations & Data	\$46,000	\$1,000,000/1,000,000
	Litigation Expense	\$83,000	\$1,000,000/2,000,000
	Total	\$300,000	
Future Formulations	None		

Policy Period January 31, 2011 through January 31, 2012

Insured Entity	Insurance Policy	Premium	Limits Occurrence/Aggregate
ICA	Products Liability	\$138,000	\$1,000,000/2,000,000
Future Formulations	Products Liability	\$31,000	\$1,000,000/1,000,000

Although there are some changes in the policies, the general descriptions of the risks insured under each policy previously provided for these policies are accurate.

2011-2012 Tax years

For 2011-2012 Rifa Jace Insurance wrote the following policies
for the following entities:

Policy Period December 15, 2011 through December 15, 2012

Insured Entity	Insurance Policy	Premium	Limits Occurrence/Aggregate
Mind Mine	Litigation Expense	\$32,000	\$1,300,000/2,000,000
	Computer Operations	\$17,000	\$1,000,000/1,000,000
	Business Risk Indemnity	\$39,000	\$1,000,000/2,000,000
	Business Income & Extra Expense	\$42,000	\$1,000,000/2,000,000
	Total	\$130,000	
ICA	Business Income & Extra Expense	\$179,000	\$1,000,000/2,000,000
	Computer Operations & Data	\$65,000	\$2,000,000/2,000,000
	Litigation Expense	\$117,000	\$1,500,000/2,000,000
	Total	\$361,000	
Future Formulations	None		

Policy Period January 31, 2012 through January 31, 2013

Insured Entity	Insurance Policy	Premium	Limits Occurrence/Aggregate
ICA	Products Liability	\$138,000	\$1,000,000/2,000,000
Future Formulations	Products Liability	\$40,000	\$2,000,000/2,000,000

Again, there are some changes in the policies; however, the general descriptions of the risks insured under each policy previously provided for these policies are applicable. One notable change in 2011 is the Business Income Extra Expense policy was expanded to include several additional covered causes of loss, including reputational damage, regulatory change, natural hazards, and supply side disruption, among others.

Terrorism Insurance Policies

The following Wilson entities purchased terrorism insurance from Pan American Reinsurance, Ltd. ("Pan American") during the years at issue.

Policy Period December 15, 2009 through December 15, 2010.

Insured Entity	Premium	Limits Occurrence/Aggregate
Mind Mine	\$54,400	\$850,000/850,000
ICA	\$217,600	\$3,350,000/3,350,000

Policy Period December 15, 2010 through December 15, 2011.

Insured Entity	Premium	Limits Occurrence/Aggregate
ICA	\$248,000	\$3,550,000/3,550,000

Policy Period December 14, 2011 through December 14, 2012.

Insured Entity	Premium	Limits Occurrence/Aggregate
Mind Mine	\$30,000	\$425,000/425,000
ICA	\$243,000	\$3,475,000/3,475,000
Future Formulations	\$10,000	\$150,000/150,000

Pan American is a fronting company licensed and regulated in Nevis. Pan American issued terrorism insurance to several insureds located across the United States. In 2009, 103 business owners (including ICA and Mind Mine) purchased terrorism insurance from Pan American. In 2010, there were 143 insureds (including ICA). In 2011, there were 112 insureds (including ICA, Future Formulations and Mind Mine). Each year, Pan American issued a

Master Certificate of insurance to the policy holders for stand-alone terrorism risk insurance coverage.

The terrorism coverage offered by Pan American is different than most coverage available on the retail market. Most notably, it offers coverage for chemical or biological agents. The terrorism insurance coverage also extends to loss of income. The terrorism coverage offered by Pan American excludes losses from acts of terrorism that occur in cities with more than 1.5 million residents. According to the U.S. Census Bureau during the years at issue, there were only four cities with populations of more than 1.5 million residents, including New York, New York, Los Angeles, California, Houston, Texas and Philadelphia, Pennsylvania.

Policies Reinsured by Rifa Jace Insurance in 2009 through 2011

Rifa Jace Insurance, along with several other captive insurance companies, reinsured the entire risk of the terrorism policies. As a reinsurer, if an insured suffered a loss and filed a claim, Rifa Jace Insurance would be responsible for a share of the resulting loss (exclusive of losses claimed by Mind Mine, ICA and/or Future Formulations).

Rifa Jace Insurance entered into a Quota Share Reinsurance Agreement with Pan American ("Quota Share Agreement") in 2009 through 2011. Pursuant to the Quota Share Agreement, in 2009 Rifa Jace Insurance assumed 1.357% of the total risk of loss for the terrorism policies written by Pan American to unrelated third party businesses. Rifa Jace Insurance was legally and financially responsible for paying total losses under the terrorism policies,

up to \$4,200,000. Rifa Jace Insurance received a premium from Pan American under the Quota Share Agreement in the amount of \$272,000.

Pursuant to the Quota Share Agreement in 2010, Rifa Jace Insurance assumed 1.08% of the total risk of loss for the terrorism policies written by Pan American to unrelated third party businesses. Rifa Jace Insurance was legally and financially responsible for paying total losses under the terrorism policies, up to \$3,525,000. Rifa Jace Insurance received a premium from Pan American under the Quota Share Agreement in the amount of \$248,000.

Pursuant to the Quota Share Agreement in 2011, Rifa Jace Insurance assumed 1.50% of the total risk of loss for the terrorism policies written by Pan American to unrelated third party businesses. Rifa Jace Insurance was legally and financially responsible for paying total losses under the terrorism policies, up to \$4,050,000. Rifa Jace Insurance received a premium from Pan American under the Quota Share Agreement in the amount of \$283,000.

The insurance premiums collected by Rifa Jace Insurance from January 1, 2009 through December 31, 2009 are as follows:

Entity	Insurance Policy	Premium Received	Percent of Total Premiums Collected
Mind Mine	Litigation Expense No. 2009-303	\$26,000	2.87%
Mind Mine	Computer Operations & Data No. 2009-302	\$16,000	1.77%
Mind Mine	Business Risk Indemnity No. 2009-301	\$62,000	6.84%
ICA	Products Liability No. 2009-201	\$92,500	10.21%
ICA	Business Income & Extra Expense No. 2009-202	\$162,000	17.88%
ICA	Computer Operations & Data No. 2009-203	\$62,000	6.84%
ICA	Litigation Expense No. 2009-204	\$90,000	9.93%
ICA	Tax Indemnity Insurance No. 2009-205	\$75,000	8.28%
Future Formulations	Employee Fidelity No. 2009-101	\$4,200	.46%
Future Formulations	Products Liability No. 2009-102	\$44,400	4.90%
Pan American	Terrorism	\$272,000	30.02%
Total		\$906,100	

The insurance premiums collected by Rifa Jace Insurance from January 1, 2010 through December 31, 2010 are as follows:

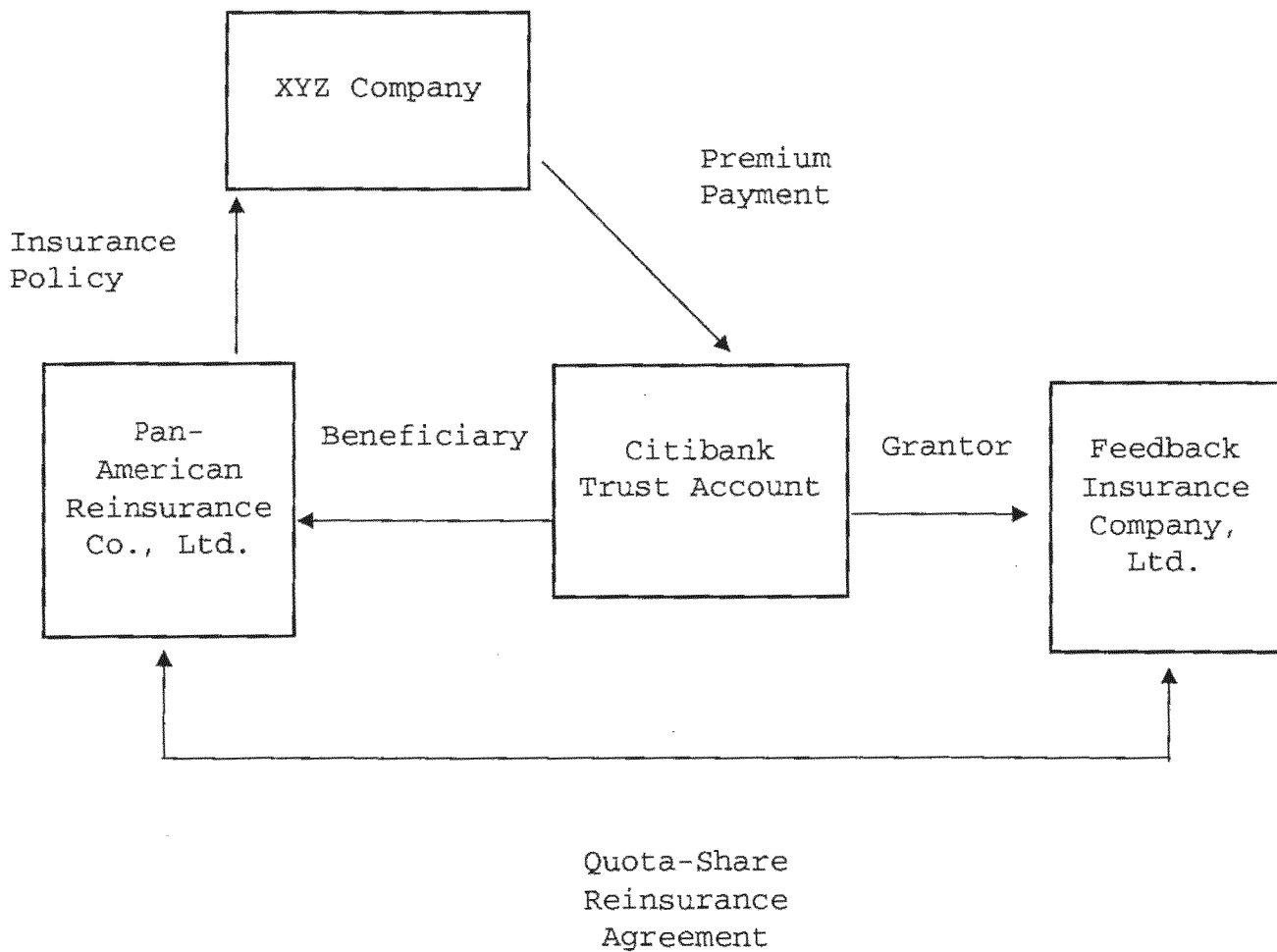
Entity	Insurance Policy	Premium Received	Percent of Total Premiums Collected
Mind Mine	Litigation Expense No. 2010-303	\$33,000	4.01%
Mind Mine	Computer Operations & Data No. 2010-302	\$16,000	1.95%
Mind Mine	Business Risk Indemnity No. 2010-301	\$62,000	7.54%
ICA	Products Liability No. 2010-201	\$132,000	16.06%
ICA	Business Income & Extra Expense No. 2010-202	\$171,000	20.80%
ICA	Computer Operations & Data No. 2010-203	\$46,000	5.60%
ICA	Litigation Expense No. 2010-204	\$83,000	10.10%
Future Formulations	Products Liability No. 2010-101	\$31,000	3.77%
Pan American	Terrorism	\$248,000	30.17%
Total		\$822,000	

The insurance premiums collected by Rifa Jace Insurance from January 1, 2011 through December 31, 2011 are as follows:

Entity	Insurance Policy	Premium Received	Percent of Total Premiums Collected
Mind Mine	Litigation Expense No. 2011-304	\$32,000	3.39%
Mind Mine	Computer Operations & Data No. 2011-303	\$17,000	1.80%
Mind Mine	Business Risk Indemnity No. 2011-302	\$39,000	4.14%
Mind Mine	Business Income & Extra Expense No. 2011-301	\$42,000	4.45%
ICA	Products Liability No. 2011-201	\$138,000	14.63%
ICA	Business Income & Extra Expense No. 2011-202	\$179,000	18.98%
ICA	Computer Operations & Data No. 2011-203	\$65,000	6.89%
ICA	Litigation Expense No. 2011-204	\$117,000	12.41%
Future Formulations	Products Liability No. 2011-101	\$31,000	3.29%
Pan American	Terrorism	\$283,000	31.01%
Total		\$943,000	

The premiums paid by the insured businesses for reinsurance were deposited into a trust account at Citi Bank. Rifa Jace Insurance entered into a Trust Agreement with Pan American, Clark (Trustee), and the other captive insurance companies who reinsured the Pan American terrorism policies. The Trust Agreement outlined the handling of the funds held in the Citibank Trust Account. In particular, 2.5% of the reinsurance premiums due to all reinsuring captive insurance companies was held in trust until the policy period expired to ensure claims could be paid should any occur.

The following diagram depicts the process previous described:



Actuary

During the years at issue, actuary Allen Rosenbach of ACR Solutions Group, Inc. set limits and determined premiums for each of the above policies. Mr. Rosenbach is a well credentialed actuary with significant experience in rate making for specialty lines of property and casualty policies. Mr. Rosenbach developed a sophisticated model he used to price the policies underwritten by Rifa Jace Insurance.

Mr. Rosenbach performed a survey of stand-alone terrorism risk insurance, and determined a reasonable rate for the stand-alone terrorism insurance for each year at issue. Mr. Rosenbach's model and processes are within acceptable actuarial standards, and the premium amounts determined by Mr. Rosenbach were reasonable and satisfy an arm's length standard.

Nevis and St. Kitts Regulation

Rifa Jace Insurance is domiciled and regulated in St. Kitts. Rifa Jace Insurance's regular insurance operations were conducted in St. Kitts by Heritor Management, Ltd. ("Heritor"). Heritor is licensed to conduct an insurance services business in St. Kitts. Heritor communicates on behalf of Rifa Jace Insurance with the regulatory commission in St. Kitts, approves and signs policies, processes claims and performs other corporate functions on behalf of Rifa Jace Insurance.

Pan American is licensed and regulated in Nevis. Pan American maintained valid insurance licenses during 2009, 2010 and 2011. Pan American is managed by Heritage Services, Ltd. Heritage is a sister company to Heritor. Heritage applied for Pan American's

insurance licenses and renewals, interfaced with the regulators and made all regulatory filings for Pan American.

Claims

The Wilson entities incurred losses covered under the insurance policies issued by Rifa Jace Insurance. Since purchasing insurance, the Wilson entities have filed the following claims:

Policy	Insured	Policy Period	Date Filed	Amount Paid
Product Liability	ICA	1/31/12-1/31/13	10/25/12	\$10,323.90
Product Liability	ICA	1/31/12-1/31/13	10/25/12	\$39,587.64
Product Liability	Future Formulations	1/31/12-1/31/13	10/25/12	\$54,587.64
Computer Operations & Data	ICA	12/15/12-12/15/13	12/19/13	\$25,360.23
Cyber Protection	ICA	12/15/12-12/15/13	12/19/13	\$36,676.91
Litigation Expense	ICA	12/15/11-12/15/12	4/17/15	\$18,967.73
General Cost of Defense	ICA	12/14/12-12/14/13	6/23/15	\$10,000.00
General Cost of Defense	Mind Mine	12/14/12-12/14/13	6/23/15	\$5,171.93
Computer Operations & Data	ICA	12/15/14-12/15/15	12/14/15	Pending
Cyber Protection	ICA	12/15/14-12/15/15	12/14/15	Pending
Total Approved Claims				\$200,675.98

Rifa Jace Insurance Investments

Dr. Wilson, in consultation with his experts, made investment decisions for Rifa Jace. Dr. Wilson is not a fan of the stock market, so he typically invested funds in the real estate market. In accordance with Dr. Wilson's investment philosophies, Rifa Jace

Insurance made a series investments in loans related to real estate transactions.

Specifically Rifa Jace Insurance had the following loans outstanding during the years at issue:

Borrower	Ending Balance		
	12/31/2009	12/31/2010	12/31/2011
5 th Street Financial	\$180,000.00	\$666,000.00	\$686,000.00
Celesta Capital	\$341,592.47	\$390,000.00	\$390,000.00
Dylaluha, LLC	\$520,207.00	\$550,000.00	\$645,000.00
Future Formulations	\$81,547.00	\$51,547.00	\$0.00
Leslie Properties	\$142,080.00	\$140,000.00	\$140,000.00
Lucky Lugh's	\$52,000.00	\$167,000.00	\$167,000.00
Ambika, LLC	\$0.00	\$225,000.00	\$180,000.00
Broad Reach Financial, LLC	\$0.00	\$350,000.00	\$170,000.00
Capener Capital, LLC	\$0.00	\$15,400.00	\$15,400.00
Farlie Financial	\$0.00	\$153,800.00	\$153,800.00
Total	\$1,317,426.47	\$2,708,747.00	\$2,547,200.00

All of the above referenced entities are owned by related parties or a trusts. Several of the loans made by Rifa Jace Insurance were used by the borrower to loan money to third parties for the purchase of real estate, which was secured by a mortgage ("third party mortgage backed loans"). Most of the third party mortgage backed loans were found by Dennis Wilson a real estate professional in Tucson, Arizona who has conducted similar business with Dr. Wilson for nearly 20 years. The third party mortgage backed loan amounts were 70 percent of the value of the secured property.

Not all of the loans from Rifa Jace were used for third party mortgage backed loans. However, Dr. Wilson believed all loans were sound investments for Rifa Jace Insurance.

These loans were documented with debt instruments containing reasonable terms. The loans had repayment schedules, the borrowers had the ability to repay the loans, and principal and interest payments were made on the loans. The loans were bona fide loans. The loans did not impair Rifa Jace Insurance's solvency.

Rifa Jace Insurance did not receive regulatory pre-approval for the loans made. However, once it was discovered pre-approval was required, the regulators were informed of the oversight and retroactive approval was granted.

BRIEF SYNOPSIS OF LEGAL AUTHORITIES:

The amounts paid and incurred by Petitioners' businesses for insurance premiums are deductible as ordinary and necessary business expenses under I.R.C. § 162.

Legal Standard

Amounts paid for insurance premiums are deductible business expenses. I.R.C. § 162, Treas. Reg. § 1.162-1(a). The term "insurance" is not defined in the Internal Revenue Code or regulations, leaving it up to the Courts to decide. In 1941, the Supreme Court determined that [h]istorically and commonly, insurance involves risk-shifting and risk-distributing. *Helvering v. LeGierse, et al.*, 312 U.S. 531, 539 (1941). Ultimately, the Tax Court developed a three-prong analysis used to determine if an arrangement is insurance for federal income tax purposes:

(1) whether the arrangement involves the existence of "insurable risks;"

(2) whether there is both risk-shifting and risk-distribution; and

(3) whether the arrangement is "insurance" in its commonly accepted sense.

Harper Group and Includible Subsidiaries v. Commissioner, 98 T.C. 4, 58 (1994), *aff'd*, 979 F.2d 1341 (9th Cir. 1992), *citing*, *AMERCO and Subsidiaries and Republic Western Insurance Company v. Commissioner*, 96 T.C. 18, 38 (1991). The above criteria are not exclusive or independent; rather, they establish the framework in determining "the existence of insurance for Federal Tax Purposes." *Rent-A-Center v. Commissioner*, 142 T.C. 1, 8 (2014); *see also AMERCO*, 96 T.C. at 38.

Furthermore, this Court has determined,

the tax treatment of an alleged insurance payment by a parent or affiliated company to a captive insurance company is to be governed by (1) facts and circumstances of the particular case and (2) principles of Federal taxation, rather than economic and risk management theories.

Harper Group, 98 T.C. at 57, *citing Moline Properties v. Commissioner*, 319 U.S. 436 (1943); *See also AMERCO*, 96 T.C. at 38.

Under the analysis applied by the U.S. Tax Court, the transaction here is insurance for federal income tax purposes.

The arrangement involves insurable risks.

To qualify as an "insurance risk," the risk being insured must be fortuitous in nature. *Commissioner v. Treganowen*, 183 F.2d 288, 290 (2nd Cir. 1950). In 2015, the U.S. Tax Court

comprehensively analyzed insurable risks in *R.V.I. Guaranty Co. LTD & Subsidiaries, v. Commissioner*. 145 T.C. 9, 15 (2015). In *R.V.I.*, the court analyzed the policies from the perspectives of the insurance company and the insured. *Id.* at 17. From the insurer's perspective, the Court determined that because the loss under the contract could exceed the premiums charged, the risks were insurance risks. *Id.* at 18. From the perspective of the insureds, the Court analyzed whether the types of losses insured were insurable in accordance with state laws and industry standards. *Id.* at 18-19.

The policies at issue here involve insurable risks. Each policy had limits clearly exposing the insurance companies to risks above the premiums charged. Here the policies purchased by the Wilson entities are policies covering risks generally insured through the insurance marketplace.

Accordingly, the arrangement at issue involves insurable risks.

The Wilson entities shifted their insured risks to Rifa Jace Insurance and Pan American.

Risk shifting occurs when one party shifts risk of loss to another. *Harper Group*, 98 T.C. at 58-59, citing *Beech Aircraft Corp v. United States*, 797 F.2d 920, 922 (10th Cir.); see also, *AMERCO*, 96 T.C. at 40.

The arrangement at issue in this case is a "brother-sister arrangement." This Court has recently articulated the proper test used in determining whether risk has shifted in the brother-sister

context is the "balance sheet and net worth analysis." *Rent-A-Center*, 142 T.C. at 14 (2014); see also, *Securitas Holdings, Inc. v. Commissioner*, T.C. Memo. 2014-225, 19-20 (2014). Under the "balance sheet" and "net worth analysis," the Court generally affords related entities separate tax status and treatment. *Id.* at 22. The Court considers the insured's assets to determine whether the insured "divested itself of the adverse economic consequences of a claim covered by the insurance policy." *Id.*

Here, Rifa Jace Insurance was formed to provide insurance, covering risks for the Wilson entities and other third parties. Rifa Jace Insurance maintained separate books and records, separate bank accounts, was financially capable of meeting its obligations, and when claims were filed and approved, it paid them. Additionally, when claims were paid by Rifa Jace Insurance, there was no adverse economic consequence to the insured. Therefore, risk shifted from the insureds to Rifa Jace Insurance. Pan American and the unrelated reinsuring insurance companies are not related to Rifa Jace Insurance or the Wilson entities. As such, there is no adverse impact on the balance sheet or net worth of the Wilson entities if for insured losses.

Rifa Jace and Pan American Distributed their Risks.

Risk distribution means the party insuring the risk distributes its personal liability, in part, among others. *Harper Group*, 96 T.C. at 59-60, (citing, *Beech Aircraft Corp.*, 797 F.2d at 922). In determining whether the captive insurance arrangement involves risk distribution, this Court considers the percentage of gross premium income received by the captive insurer from unrelated

insureds. *Harper Group*, 96 T.C. at 60, n. 10. This Court concluded that risk distribution occurred in the captive insurance arena when insurance issued to unrelated insureds comprised approximately 30% of the total premiums. *Harper Group*, 96 T.C. at 59-60, and 60, n. 10, (citing, *AMERCO*, 96 T.C. 18). Further, perfect independence is not required for risk distribution. *R.V.I.* 145 T.C. at 14, relying on *Rent-A-Center* 142 T.C. at 24; *Harper Group* 96 T.C. at 55, 59-60 and *Gulf Oil Corp. v. Commissioner*, 89 T.C. 1010, 1025 n. 9 (1987).

In 2009, Rifa Jace Insurance received premiums from third parties comprising 30% of the total premiums received for the year. Rifa Jace Insurance reinsured risks for 101 third parties (exclusive of its brother-sister entities). In 2010, Rifa Jace Insurance received premiums from third parties comprising 30.17% of the total premiums received for the year. Rifa Jace Insurance reinsured risks for 138 third parties (exclusive of its brother-sister entities). In 2011, Rifa Jace Insurance received premiums received from third parties comprising of 30% of the total premiums for the year. Rifa Jace Insurance reinsured risks for 109 third parties (exclusive of its brother-sister entities). Thus, under this Court's precedent Rifa Jace Insurance distributed its risk.

Additionally, Rifa Jace Insurance underwrote five different policies issued to three separate entities. Each policy covering losses related to different risks adding to Rifa Jace Insurance's spread of risk.

The arrangement is insurance in the commonly accepted sense.

In determining whether an arrangement is insurance in the commonly accepted sense, this Court considers the following factors: (1) whether the insurer was organized, operated and regulated as an insurance company; (2) whether the insurer was adequately capitalized; (3) whether the insurance policies were valid and binding; (4) whether the premiums were reasonable; and (5) whether the premiums were paid and the losses were satisfied. *Securitas Holdings*, T.C. Memo. 2014-225, 27.

The insurance arrangement at issue here is insurance in the commonly accepted sense. Rifa Jace Insurance was properly formed, conducts annual meetings, maintains separate bank accounts and books and records, and is licensed and regulated by St. Kitts. Rifa Jace Insurance is adequately capitalized and the policies issued were valid and binding. The premiums were actuarially determined and reasonable in amount. Finally, the premiums were paid by the insureds and, when losses occurred, the approved claims were paid.

The amounts paid by Petitioners' businesses for the years at issue were paid to an insurance company for insurance.

As previously discussed, Rifa Jace Insurance is a valid insurance company regulated in St. Kitts. The insurance arrangement at issue constitutes insurance for federal income tax purposes. I.R.C. § 816(a) provides,

[T]he term 'insurance company' means any company more than half of the business of which during the taxable year is the issuing of insurance or annuity contracts or the reinsuring of risks underwritten by insurance companies.

100% of Rifa Jace Insurance's business in 2009, 2010 and 2011 was issuing direct insurance contracts and reinsuring risks underwritten by a fronting company.

The insurance transactions between Petitioners' businesses and Rifa Jace Insurance Company, Ltd. in the 2009 through 2011 tax years had economic substance, the substance of the transactions comports with the form, and the transactions were not engaged solely for the purpose to avoid or evade tax.

Separate entities must be respected as such for tax purposes. *Moline Properties, Inc. v. Commissioner*, 319 U.S. 436, 63 S.Ct. 1132, 87 (1943). However, substance over form is a limited exception to this general rule. *Clougherty Packing Company v. Commissioner*, 811 F.2d 1297, 1302 (9th Cir. 1987). This exception exists where "Congress evidenced an intent to the contrary or where the corporate form is but a sham." *Id.* at 1302. Here, Petitioners formed a small insurance company to insure risks of their businesses, which is permitted under the Internal Revenue Code.

Indeed, the legislative history shows that Congress's intent in creating I.R.C. § 831(b) was to simplify reporting requirements for small insurance companies, allowing small companies to utilize captive insurance companies to insure their risks. The 1986 Act treated all small property and casualty insurance companies, whether stock or mutual, in the same manner, exempting from taxation under § 501(c)(15) companies with net written premiums (or direct written premiums, if greater) not exceeding \$350,000, and permitting companies with net written premiums (or direct

written premiums, if greater) of between \$350,000 and \$1,200,000 to elect under § 831(b) to be taxed only on their investment income. Tax Reform Act § 1024, 100 Stat. at 2405-06. The Joint Committee on Taxation has explained this legislative decision as follows:

Congress determined that the prior-law rules applicable to small and certain ordinary mutual companies were inordinately complex and should be simplified. Congress concluded that one provision should afford benefits comparable to prior law to small mutual companies. Further, Congress concluded that it was appropriate to eliminate the distinction between small mutual companies and other small companies, and extended the benefit of the small company provision to all eligible small companies, whether stock or mutual.

General Explanation, at 620. Consistently, Petitioners formed Rifa Jace to provide insurance to the Wilson entities.

Economic substance in the insurance context boils down to risk shifting and risk distribution. This Court agrees with the Sixth Circuit's determination in *Humana Inc.*, and has held when applying the economic substance standard in cases involving insurance,

[t]he test to determine whether a transaction under the Internal Revenue Code §162(a)***is legitimate or illegitimate is not a vague and broad 'economic reality' test. The test is whether there is risk shifting and risk distribution.

Rent-A-Center, 142 T.C. at *12, see also *Humana Inc.*, 881 F.2d at 254-255. Here, risks shifted from the insureds to Rifa Jace

Insurance and Pan American, and both insurance companies distributed the insured risks.

Finally, the Ninth Circuit has determined that providing insureds with increased insurance coverage gives a transaction economic substance. See *Shirar v. Commissioner*, 916 F.2d 1414 (9th Cir. 1990) (The Ninth Circuit determined the Tax Court erred in finding an insurance transaction did not have economic substance when the transaction provided increased insurance coverage. The Ninth Circuit held the transaction had economic substance and was not a transaction solely for tax benefits.). It is undisputed that both Rifa Jace Insurance and Pan American provided additional insurance coverage to the Wilson entities.

Clearly, Petitioners had a valid business purpose for forming Rifa Jace Insurance, and the insurance transactions at issue had economic substance.

Additionally, the step transaction doctrine is also not applicable to this case. This doctrine "treats multiple transactions as a single integrated transaction for tax purposes if all of the elements of at least one of three tests are satisfied: (1) the end result test, (2) the interdependence test, or (3) the binding commitment test." *Linton v. U.S.*, 630 F.3d 1211, 1224 (9th Cir. 2011) (citing *True v. United States*, 190 F.3d 1165, 1174-75 (10th Cir. 1999)).

The most far-reaching test is the end result test. *Klauer v. Commissioner*, T.C. Memo. 2010-65 at *19. Under the end result test, this Court has held a taxpayer's subjective intent is significant to determine whether the taxpayer "directed a series of transactions to an intended purpose." *Klauer*, T.C. Memo. 2010-65 at *21 (citing *Brown v. United States*, 782 F.2d 559, 563 (6th Cir. 1986)). Steps that are transitory, meaningless, or lacking in a nontax, business purpose may be disregarded for purposes of determining the true nature of a transaction." *Klauer*, T.C. Memo. 2010-65 at *19 (citing *Minn. Tea Co. v. Helvering*, 302 U.S. 609, 613 (1938)). Here, the transaction has significant non-tax business purposes - providing additional insurance, improving risks management, and transparent claims filing process, among others.

Petitioners are not liable for penalties or additions to tax under I.R.C. § 6662 for the 2009 through 2011 tax years.

The Commissioner bears the burden of production on the applicability of all accuracy-related penalties, and must come forward with sufficient evidence indicating that it is proper to impose them. I.R.C. § 7491(c). If the Commissioner meets his burden of production, the burden of proof remains with Petitioners, including the burden of proving that the penalty is inappropriate because of reasonable cause. *Higbee v. Commissioner*, 116 T.C. 438, 446-47 (2001). Further, with regard to *Future Formulations, LLC v. Commissioner*, Docket No. 15011-14 respondent raised a

penalty or addition to tax pursuant to I.R.C. § 6662(a) on Answer therefore; he bears the burden of proof.

In accordance with Tax Court Rule 142(a)(1), the Commissioner bears the burden of proof on any new matters, increases in deficiencies, or affirmative defenses. This Court has developed a standard in determining whether an issue not raised in the notice of deficiency constitutes a new matter, shifting the burden of proof to the respondent pursuant to Rule 142. Namely, a "new matter" is one that reasonably would change the evidence required, and a "new theory" is conversely a new argument about the existing evidence. *Hurst v. Commissioner*, 124 T.C. 16, 30 (2005). A new assertion by respondent that either alters the amount of the original deficiency notice or requires the presentation of different evidence constitutes a "new matter." *Sanderling, Inc. v. Commissioner*, 66 T.C. 743, 757-758 (1976).

Respondent not only bears the burden of proving the addition to tax under Section 6662(a) is proper, he also has the burden of showing absence of reasonable cause. *Sanderling*, 66 T.C. at 757-758 (Respondent bore the burden of proving the applicability of addition to tax under Section 6651 and absence of reasonable cause because the addition to tax was asserted for a different reason and in an increased amount in his Amended Answer.). See also *McMillan v. Commissioner*, T.C. Memo. 2015-109, 11-12 (Respondent bore the burden of proof for accuracy

related penalty under Section 6662 asserted in his Answer. Respondent's burden of proof includes a showing of absence of reasonable cause.)).

The accuracy-related penalty is not applicable if the Petitioners acted with reasonable cause and in good faith with respect to the claimed deductions at issue. I.R.C. § 6664(c)(1), Treas. Reg. § 1.662-4(d)(1). Reasonable cause requires that the taxpayer have exercised ordinary business care and prudence as to the disputed item. *Calypso Music Inc. v. Commissioner*, T.C. Memo. 2000-293, 5 (2000). "The good faith, reasonable reliance on the advice of an independent, competent professional as to the tax treatment of an item may meet this requirement." See *Id.*; Sec. 1.6664-4(b), Income Tax Regs.; see also *Ewing v. Commissioner*, 91 T.C. 396, 423, 1988 WL 89128 (1988), *affd.* without published opinion 940 F.2d 1534 (9th Cir. 1991).

Whether a taxpayer reasonably relied on professional advice "is determined by the facts and circumstances of the case and the law that applies to those facts and circumstances." *Calypso*, T.C. Memo. 2000-293, 5; see also sec. 1.6664-4(c)(i), Income Tax Regs. "A professional may render advice that may be relied upon reasonably when he or she arrives at that advice independently, taking into account, among other things, the taxpayer's purposes for entering into the underlying transaction." See sec. 1.6664-4(c)(i), Income Tax Regs.; see also *Leonhart v. Commissioner*, 414 F.2d 749 (4th Cir. 1969), *affg.* T.C. Memo. 1968-98 (*citing Calypso*, T.C. Memo. 2000-293, 5).

Here, Petitioners took reasonable efforts to determine their proper income tax liabilities. Dr. Wilson sought the advice of his trusted attorney, Mr. Smith, with whom Dr. Wilson had prior engagement. Mr. Smith is well credentialed, experienced and competent regarding tax matters. Petitioners also relied upon the advice of Clark, who is equally credentialed, experienced and competent on the matters at issue.

Additionally, the amount of an understatement may be "reduced by that portion of the understatement which is attributable to the tax treatment of any item by the taxpayer if there is or was substantial authority for such treatment." 26 U.S.C. § 6662(d)(2)(B)(i). In determining if there is reasonable basis for positions on a return, the regulations guide taxpayers to the same list of authorities which a taxpayer may rely for substantial authority. Treas. Reg. Section 1.6662-3(b)(3) (citing Treas. Reg. Section 1.6662-4(d)(3)(iii)).

Substantial authority is an objective standard that has two elements: whether there was "authority" for a position, and if so, whether that authority was "substantial." Treas. Reg. Section 1.6662-4(d)(1). This standard is "less stringent than the more likely than not standard (the standard is met when there is a greater than 50-percent likelihood of the position being upheld), but more stringent than the reasonable basis standard." Treas. Reg. Section 1.6662-4(d)(2). Also, "a taxpayer may have substantial authority for a position that is supported only by a well-reasoned construction of the applicable statutory provision." Treas. Reg. Section 1.6662-4(d)(3)(ii).

Here, there is reasonable basis for the positions taken on Petitioners' returns. See I.R.C. § 831(b), *Harper Group, supra*; *AMERCO, supra*; *Rent-A-Center, supra*; and, *Securitas, supra*.

Finally, there is substantial authority regarding captive insurance generally, and this case falls squarely within the authority developed through case law on this issue. However, Petitioners are unaware of any opinion of this Court regarding a captive insurance company operating under a section 831(b) election. Because there is no clear authority whether a section 831(b) captive insurance company should be treated differently than one that is not, negligence penalties are inappropriate in this case. See *Foster v. Commissioner*, 756 F.2d 1430, 1439 (9th Cir. 1985) (The Court determined in a case of first impression, with no clear authority to guide the decision makers as to the major and complex issues, a negligence penalty is inappropriate.); see also, *Williams v. Commissioner*, 123 T.C. 144, 153-154 (2004) (concluding reasonable cause may be found where a return position involves issues of first impression at the time the return was filed).

Based upon the above, Petitioners had reasonable cause and good faith for positions taken on their income tax returns for the years at issue.

EVIDENTIARY PROBLEMS:

The parties are still in the process of completing the Stipulation of Facts. There are no known evidentiary problems at this time.

Date: _____

7/29/16



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