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Date 9/29/97

Signature [redacted]

[redacted]

CP:E:EO:T:3

Employer Identification Number: [redacted]

JUN 10 1996

Dear Taxpayer:

This refers to your application for recognition of exemption from federal income tax as an organization described in section 501(c)(15) of the Internal Revenue Code

The information furnished shows that you were incorporated under [redacted] You applied for recognition of exemption under section 501(c)(15) of the Code on [redacted]. You are seeking exemption for [redacted]

The information furnished shows that your shareholders are [redacted] is the [redacted] percent interest in you.

[redacted], and [redacted] each have a [redacted] interest in [redacted], (hereafter [redacted], a seller of mobile homes. [redacted] is [redacted] spouse. [redacted] and [redacted] are [redacted]

The information furnished shows that [redacted] customers are offered an opportunity to purchase service/warranty contracts. These contracts are not contracts of insurance under [redacted] (hereafter [redacted] acts as Administrator for the service/warranty contracts. [redacted] provides [redacted] copies of such service/warranty contracts. [redacted] applies for insurance with [redacted] (hereafter [redacted] through [redacted] to cover its risk under the service/warranty contracts.

If a claim occurs under the service/warranty contracts the customer contacts [redacted], and if the part is covered [redacted] repairs it. Then, [redacted] applies to [redacted] for reimbursement.

You state that you are a captive reinsurance company which reinsures the [redacted] insurance contract which insures [redacted] risk under the service/warranty contracts.

You entered into a reinsurance contract with [redacted] effective [redacted] Under this contract, [redacted] cedes and you accept as reinsurance [redacted]% of [redacted] service contract reimbursement liability under all service contract reimbursement liability insurance written or assumed by [redacted] under [redacted].

The financial information furnished shows that you had net written premiums in the amount of $[redacted] in [redacted] and $[redacted] in [redacted]. You did not furnish information concerning the amount of written premium income received in [redacted].

Section 501(c)(15)(A) of the Code recognizes as exempt "[i]nsurance companies or associations other than life (including interinsurers and reciprocal underwriters) if the net written premium (or,if greater, direct written premiums) for the taxable year do not exceed $350,000."

Section 501(c)(15)(B) of the Code provides that "[f]or purposes of subparagraph (A), in determining whether any company or association is described in subparagraph (A), such company or association shall be treated as receiving during the taxable year amounts described in subparagraph (A) which are received during such year by all other companies or associations which are members of the same controlled group as the insurance company or association for which the determination is being made."

Section 501(c)(15)(C) of the Code provides that "[f]or purposes of subparagraph (B), the term controlled group has the meaning given such term by section 831(b)(2)(B)(ii).

Section 831(b)(2)(B)(ii) of the Code provides that:

> "[f]or purposes of clause (i) the term 'controlled group' means any controlled group of corporations (as defined in section 1563(a)); except that -
>
> (I) 'more than 50 percent shall be substituted for 'at least 80 percent' each place it appears in section 1563(a), and
>
> (II) subsections (a)(4) and (b)(2)((D) shall not apply."

Section 1563(a)(2)(B) of the Code defines the term "brother-sister controlled group" to mean "[t]wo or more corporations if 5 or fewer persons who are individuals, estates, or trusts own (within the meaning of subsection (d)(2)) stock possessing more than 50 percent of the total combined voting power of all classes of stock entitled to vote or more than 50 percent of the total value of shares of all classes of stock of each corporation,

taking into account the stock ownership of each such person only to the extent such stock ownership is identical with respect to each corporation."

Section 1563(d)(2)(B) of the Code states that "[f]or purposes of determining whether a corporation is a member of a brother-sister controlled group of corporations ... stock owned by a person who is an individual, estate, or trust means (A) stock owned directly by such person, and (B) stock owned with the application of subsection (e)".

Section 1563(e)(5) of the Code states, in pertinent part, that a individual shall be considered as owning stock in a corporation owned directly, or indirectly by or for his spouse...."

The term "insurance company" has the same meaning under section 501(c)(15) as under Subchapter L of the Code (relating to taxation of insurance companies). See II Conf. Rep. No. 99-841, 99th Cong. 2d Sess. 370-71, reprinted in 1986-3 (Vol.4) C.B. 370-71; see also Rev. Rul. 74-196, 1974-1 C.B. 140, for a similar conclusion under prior law.

Section 1.801-3(a)(1) of the Income Tax Regulations defines the term "insurance company" to mean a company whose primary and predominant business activity during the taxable year is the issuing of insurance or annuity contracts or the reinsuring of risks underwritten by insurance companies. Thus, though its name, charter powers, and subjection to State insurance laws are significant in determining the business which a company is authorized and intends to carry on, it is the character of the business actually done in the taxable year which determines whether a company is taxable as an insurance company under the Internal Revenue Code. See also Bowers v. Lawyers Mortgage Co., 285 U.S. 182 (1932).

Rev. Rul. 68-27, 1968-1 C.B. 315, provides, in part, that the meaning of the term "insurance company" as defined in section 1.801-3(a) of the regulations is equally applicable to insurance companies other than life. See sections 1.831-1(a) and 1.831-3(a) of the regulations. Thus, the primary and predominant business activity of an organization qualifying as an insurance company must be the issuing of insurance contracts. In Rev. Rul. 68-27, since the predominant business activity of the organization was not the issuance of insurance contracts, the organization did not qualify as an insurance company.

The principal test for what constitutes "insurance" is set out in Helvering v. LeGierse, 312 U.S. 531 (1941). In that case the Supreme Court states that "[h]istorically and commonly insurance involves risk-shifting and risk-distribution...."

adequate consideration, one party undertakes to indemnify another against loss from certain specified contingencies or perils...."

In Commissioner v. Treganowan, 183 F.2d 288 (2nd Cir. 1950), the court defines the terms "risk shifting" and "risk distribution" in the following way:

> Risk shifting emphasizes the individual aspect of insurance: the effecting of a contract between the insurer and insured each of whom gambles on the time [when a loss will occur]. Risk distribution ... emphasizes the broader, social aspect of insurance as a method of dispelling the danger of a potential loss by spreading its cost throughout a group.

In Humana Inc. v. Commissioner, 881 F.2d 247, (6th Cir. 1989), the court concluded that the first prong of the LeGierse test, "risk shifting," had been met. The court stated that the second prong of the LeGierse test, "risk distribution," must also be met. The court concluded that:

> [R]isk distribution involves shifting to a group of individuals the identified risk of the insured. The focus ... looks more to the insurer as to whether the risk insured against can be distributed over a larger group rather than the relationship between the insurer and any single insured .... [I]nsurance must consist of both risk shifting and risk distribution.... [T]he definition of an insurance contract depend[s] on meeting both of the prongs of the test. Risk transfer and risk distribution are two separate and distinct prongs of the test and both must be met to create an insurance contract. An arrangement between a parent corporation and a captive insurance company in which the captive insures only the risks of the parent might not result in risk distribution. Any loss by the parent is not subject to the premiums of any other entity.

In Anesthesia Service Medical Group v. Commissioner, 85 T.C. 1031 (1985), aff'd, 825 F. 2d 241 (9th Cir. 1984), the court held that a trust, created to provide medical malpractice coverage to the employees of a medical group, that was itself controlled by the medical group, was not an insurance company

because the risks of the employees were, in effect, the risks of the medical group, under the doctrine of respondeat superior. Thus, there was no shifting and distribution of the risk of loss to unrelated parties, and no "insurance."

In Malone & Hyde Inc. Commissioner of Internal Revenue, 62 F. 3d 835 (6th Cir. 1995), the facts show that Malone & Hyde, (MH) formed an offshore insurance subsidiary, Eastland Insurance, Ltd (EIL) to reinsure the first $150,000 coverage of the insurance MH obtained from Northwestern National Insurance Company (NNIC) for itself and its subsidiaries. Initially in 1986, the tax court held MH was not entitled to a section 162 deduction of the premium payments made to NNIC which were reinsured with EIL. Because of the decision in Humana, the Court reconsidered its decision in Malone & Hyde. The Commissioner responded that (a) the hold harmless agreements, (b) the irrevocable letters of credit, and (c) EIl's thin capitalization distinguished the Malone & Hyde case from the Humana case. The Court found in favor of MH and outlined the following three part test for determining whether a transaction involved insurance for income tax purposes: (1) whether the transaction involved "insurance risks"; (2) whether there is risk shifting and risk distribution; and (3) whether there is insurance in its commonly accepted usage. On appeal the Sixth Circuit concluded that the tax court should have first (i) determined whether MH created EIL for a legitimate business purpose, and/or (ii) determined whether EIL was a sham corporation. The Sixth Circuit concluded that MH had no legitimate business reason for establishing EIL, whereas in the Humana case, Humana could not obtain insurance in the open market and thus had a legitimate reason for establishing a controlled captive. Further, the Sixth Circuit concluded that EIL was thinly capitalized whereas in the Humana case, the Humana insurance subsidiary was not thinly capitalized. The Court held that EIL, a thinly capitalized captive foreign subsidiary, was a sham corporation propped up by its parent, MH. Further, the Court concluded that even though EIL, the foreign subsidiary, met the minimum capitalization requirements of its country of jurisdiction, there was no risk shifting. Thus, since there was no shifting and distribution of the risk of loss to unrelated parties, there was no insurance.

Rev. Rul. 77-316, 1977-2 C.B. 53, describes a situation where a domestic parent and its domestic subsidiaries enter into a contract for fire and casualty insurance with a newly formed foreign insurance subsidiary of the parent. The foreign insurance subsidiary did not accept risks from parties other than the parent and its domestic subsidiaries. It was reasoned that since those who bear the ultimate economic burden of loss are the same persons who suffer the loss, there is neither shifting nor distribution of the risk of loss to unrelated parties and no insurance. Further, it was concluded that such a brother-sister

those who bear the ultimate economic burden of loss are the same persons who suffer the loss, there is neither shifting nor distribution of the risk of loss to unrelated parties and no insurance. Further, it was concluded that such a brother-sister captive arrangement does not constitute the issuing of insurance or annuity contracts or the reinsuring of risks underwritten by insurance companies within the meaning of section 1.801-3(a)(1) of the regulations. Accordingly, it was held that the captive insurance subsidiary was not an insurance company within the meaning of section 1.801-3(a)(1) of the regulations. (Rev. Rul. 77-316, supra, has been amplified and clarified by Rev. Rul. 88-72, 1988-2 C.B. 31)

Rev. Rul. 88-72, 1988-2 C.B. 31, as clarified by Rev. Rul. 89-61, 1989-1 C.B. 75, explains the difference between risk shifting and risk distribution. Risk shifting occurs where a risk is shifted away from a corporate parent and its subsidiaries. Risk distribution occurs when an insurance company accepts a large number of independent risks, and thereby takes advantage of a statistical phenomenon known as the "law of large numbers." Although the potential loss exposure increases, the average loss incurred becomes increasingly predictable.

The threshold issue is whether you are an insurance company since you only reinsure the liability insurance contract issued by [redacted] to [redacted], which covers [redacted] liability under the service/warranty contracts it sells to its customers.

As noted above, [redacted] and [redacted] each own [redacted] of your stock.

[redacted]% of [redacted] stock. Further, [redacted], and [redacted], each own [redacted]% of [redacted] stock. Accordingly, pursuant to section 1563(e)(5) of the Code, [redacted] constructively owns the [redacted]% of the [redacted] stock owned by [redacted]. Further, pursuant to section 1563(e)(5) of the Code, [redacted] owns the [redacted]% of the stock owned by [redacted]. Accordingly, we conclude that [redacted] each own [redacted]% of DHI's stock.

Because five or fewer persons own (within the meaning of section 1563(d)(2) of the Code) stock possesing more than 50 percent of the total combined voting power of all classes of stock entitled to vote, taking into account the stock ownership of each such person only to the extent such stock ownership is identical with respect to each such corporation, we conclude that you and [redacted] are controlled corporations within the meaning of section 1563 of the Code. Accordingly, we conclude that you are not an insurance company since you only reinsure the liability insurance contract which insures [redacted] risk under the service/warranty contracts it sells to its customers. Thus, there

is no shifting and distribution of the risk of loss to unrelated parties. Therefore, we conclude that you do not meet either of the two prongs of the LeGierse test, "risk shifting," and "risk distribution," and there is no "insurance."

Further, since under section 1563(e)(5) of the Code [redacted] all of your stock and [redacted] stock, and since you have, in effect, assumed [redacted] liability under the service/warranty contracts [redacted] sells to its customers, we conclude that this arrangement resembles the self-insurance arrangements described in Rev. Rul. 77-316, which were found not to involve risk shifting. Since all of your business is derived from this self-insurance arrangement, we conclude that [redacted] is not an insurance company as defined by section 1.801-3(a)(1) of the regulations.

Moreover, and more important, because you are a thinly capitalized foreign corporation, and because there is no shifting and distribution of the risk of loss to unrelated parties, we conclude that you are like the organization that is the subject of the Malone & Hyde case. Therefore, we conclude that since there was no legitimate business purpose for your formation, you are a "sham corporation" like the organization described in Malone & Hyde, supra.

Based on the above, we conclude that you do not qualify for recognition of exemption under section 501(c)(15) of the Code.

You are required to file federal income tax returns.

You have the right to protest this ruling if you believe it is incorrect. To protest, you should submit a statement of your views, with a full explanation of your reasoning. This statement, signed by one of your officers, must be submitted within 30 days of the date of this letter. You also have a right to a conference in this office after your statement is submitted. You must request the conference, if you want one, when you file your protest statement. If you are to be represented by someone who is not one of your officers, that person will need to file a proper power of attorney and otherwise qualify under our Conference and Practices Requirements.

You will expedite our receipt of your protest statement by using the following address on the envelope:

CP:E:EO:T:3, Room 6137
Internal Revenue Service
1111 Constitution Ave.
Washington, D.C. 20224

[redacted]

If we do not hear from you within 30 days, this ruling will become final and copies will be forwarded to the Southeast key District Office, which is located in Baltimore, Maryland. Thereafter, any question about your federal income status should be addressed to that office.

Enclosure:
Key District List

Sincerely yours,

Edward K. Karcher

Edward K. Karcher
Chief, Exempt Organizations
Technical Branch 3

cc: DD, Southeast (Baltimore)
Attn: EO Group
cc: [redacted]

CP:E:EO:T:3 CP:E:EO:T:3 CP:E:EO:T:3

[redacted] [redacted] [redacted]