TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

Number: **200603030**
Release Date: 01/20/2006
SE:T:EO:RA:T:3

Date: October 25, 2005

Index (UIL) No.: 501.15-00

Contact Person:

Identification Number:

Contact Number:

Employer Identification Number:

Form Required To Be Filed:

Tax Years:

Dear :

This is our final determination that you do not qualify for exemption from Federal income tax under Internal Revenue Code section 501(a) as an organization described in Code section 501(c)(15).

We made this determination for the following reason(s):

Your insurance arrangement involves only one type of insurance contract. This arrangement does not qualify as an insurance arrangement for federal income tax purposes because there is no risk distribution. Because the arrangement does not qualify as insurance for federal income tax purposes, you do not qualify as an insurance company for and .

You must file Federal income tax returns on the form and for the years listed above within 30 days of this letter, unless you request an extension of time to file. File the returns in accordance with their instructions, and do not send them to this office. Failure to file the returns timely may result in a penalty.

We will make this letter and our proposed adverse determination letter available for public inspection under Code section 6110, after deleting certain identifying information. Please read the enclosed Notice 437, *Notice of Intention to Disclose,* and review the two attached letters that show our proposed deletions. If you disagree with our proposed deletions, follow the instructions in Notice 437. If you agree with our deletions, you do not need to take any further action.

If you have any questions about this letter, please contact the person whose name and telephone number are shown in the heading of this letter. If you have any questions about your Federal income tax status and responsibilities, please contact IRS Customer Service at 1-800-829-1040 or the IRS Customer Service number for businesses, 1-800-829-4933. The IRS Customer Service number for people with hearing impairments is 1-800-829-4059.

Sincerely,

Lois G. Lerner
Director, Exempt Organizations
Rulings & Agreements

Enclosure
Notice 437
Redacted Proposed Adverse Determination Letter
Redacted Final Adverse Determination Letter

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

Date: 06/16/05

Contact Person:

Identification Number:

Contact Number:

Index (UIL) No.: 501.15-00
No Third Party Contact.

O =
P =
Q =
R =
Date S =
X =

Employer Identification Number:

Dear

We have considered your application for recognition of exemption from federal income tax under section 501(a) of the Internal Revenue Code as an organization described in section 501(c)(15) of the Code. Based on the information submitted, we have concluded that you do not qualify for exemption under that section. The basis for our conclusion is set forth below.

You were incorporated in the O Islands on Date S. You filed Form 1024, Application for Recognition of Exemption under Section 501(a), stating that you meet the requirements of section 501(c)(15) of the Code. Thereafter, you filed an election under section 953(d) of the Code to be treated as a U.S. domestic insurance company. Your stated purpose is to sell property and casualty insurance.

At incorporation, you were funded with a capital contribution of $x million from your sole shareholder P. P sold certain investment property to obtain these funds. As stated in your Form 990, Return of Organization Exempt from Income Tax for [redacted], your total revenue was $[redacted] In an April 6, 2004, letter from your attorney Q, Q states that "your organization holds and will maintain readily liquid assets in the form of securities, certificates of deposits and cash. Your organization will maintain a balanced long-term asset portfolio that will also consist of some real estate related investments."

Q further states in the April 6, 2004 letter that your organization maintains one employee—its CEO P. To date, you have written five contracts. You insure medical spa coverage and experimental aviation coverage. You state that you reinsure all policies you write.

On December 15, 2001, you wrote three Income Replacement Insurance Policies to persons unrelated to P. The gross annual premiums for these contracts were $[redacted] The maximum annual gross liability for all three contracts totaled $[redacted]. Also, on December 15, 2001, you reinsured a large portion of your liability under the three contracts. After reinsurance, your maximum annual net liability for all three contracts totaled $[redacted] The terms for the three contracts were for one year expiring December 15, 2002.

On December 26, 2003, you wrote one Professional Liability Insurance Policy for Cosmetic Medicine and Laser Treatment for one insured, who paid a premium of $[redacted] The contract's term was for one year. The aggregate liability limit for this contract is $[redacted]

On December 30, 2003, you wrote an Aviation Liability Insurance Policy for R. R is wholly owned by your sole shareholder, P. In addition, P is the pilot and owner of the plane insured by you. While the contract in the file does not provide any details about the premium paid or the benefit amount, the letter from the actuarial consulting group hired by you states that they were provided with a copy of an aircraft property and liability contract to be written by you. The annual premium for this contract would be $[redacted] The contract would provide $[redacted] coverage with a $[redacted] deductible. There would be liability coverage limits of $[redacted] per person and $[redacted] per occurrence. There is no evidence that the actual contract you sold to R was for these terms. There is also no evidence of you reinsuring the aviation contract.

LAW:

Section 501(c)(15) of the Code recognizes as exempt insurance 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 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 Bowers v. Lawyers Mortgage Co., 285 U.S. 182 (1932).

Neither the Code nor the regulations define the term "insurance." The United States Supreme Court, however, has explained that in order for an arrangement to constitute insurance for federal income tax purposes, both risk shifting and risk distribution must be present. Helvering v. Le Gierse, 312 U.S. 531 (1941). Further, the Court states that "the risk must be an 'insurance risk' as opposed to an 'investment risk'..." Id. at 542. In Allied Fidelity Corp. v. Comm'r, 66 T.C. 1068, 1074 (1976), aff'd 572 F.2d 1190 (7th Cir. 1978), the Tax Court wrote that this risk is a risk of "a direct or indirect economic loss arising from a defined contingency," so that an "essential feature of insurance is the assumption of another's risk of economic loss."

Risk shifting occurs if a person facing the possibility of an economic loss transfers some or all of the financial consequences of the potential loss to the insurer, such that a loss by the insured does not affect the insured because the loss is offset by the insurance payment. Risk distribution incorporates the statistical phenomenon known as the law of large numbers. Distributing risk allows the insurer to reduce the possibility that a single costly claim will exceed the amount taken in as premiums and set-aside for the payment of such a claim. By assuming numerous relatively small, independent risks that occur randomly over time, the insurer smoothes out losses to match more closely its receipt of premiums. Clougherty Packing Co. v. Comm'r., 811 F.2d 1297, 1300 (9th Cir. 1987). Risk distribution necessarily entails a pooling of premiums, so that a potential insured is not in significant part paying for its own risks. See Humana, Inc. v. Comm'r., 881 F.2d 247, 257 (6th Cir. 1989).

In Humana, the United States Court of Appeals for the Sixth Circuit held that arrangements between a parent corporation and its insurance company subsidiary did not constitute insurance for federal income tax purposes. The court also held, however, that arrangements between the insurance company subsidiary and several dozen other subsidiaries (operating an even larger number of hospitals) qualified as insurance for federal income tax purposes because the requisite risk shifting and risk distribution were present. But see Malone & Hyde, Inc. v. Comm'r, 62 F.3d 835 (6th Cir. 1995) (concluding the lack of a business purpose, the undercapitalization of the offshore captive insurance subsidiary and the existence of related party guarantees established that the substance of the transaction did not support the taxpayer's characterization of the transaction as insurance). In Kidde Industries, Inc. v. U.S., 40 Fed. Cl. 42 (1997), the United States Court of Federal Claims concluded that an arrangement between the captive insurance subsidiary and each of the 100 operating subsidiaries of the same parent constituted insurance for federal income tax purposes. As in Humana, the insurer in Kidde insured only entities within its affiliated group during the taxable years at issue.

No court has held that a transaction between a parent and its wholly owned subsidiary satisfies the requirements of risk shifting and risk distribution if only the risks of the parent are "insured." See Stearns-Roger Corp. v. U.S., 774 F.2d 414 (10th Cir. 1985); Carnation Co. v. Comm'r., 640 F. 2d 1010 (9th Cir. 1981), cert. denied 454 U.S. 965 (1981). However, courts have held that an arrangement between a parent and its subsidiary can constitute insurance because the parent's premiums are pooled with those of unrelated parties if (i) insurance risk is present, (ii) risk is shifted and distributed, and (iii) the transaction is of the type that is insurance in the commonly accepted sense. See, e.g., Ocean Drilling & Exploration Co. v. U.S., 988 F.2d 1135 (Fed. Cir. 1993); AMERCO, Inc. v. Comm'r., 979 F.2d 162 (9th Cir. 1992).

In Clougherty Packing Co. v. Comm'r, 811 F.2d 1297 (9th Cir. 1987), Clougherty Packing purchased workers' compensation insurance from an unrelated insurer who then reinsured with Lombardy Insurance Corporation, a wholly owned subsidiary of one of Clougherty Packing's wholly owned subsidiaries (a second tier subsidiary). Lombardy had no business other than that attributable to the reinsurance of Clougherty's workers' compensation liabilities. As stated in Clougherty, several courts outside of the 9th circuit have addressed the captive insurance issue, and none has found that a policy provided by a wholly owned subsidiary that exists solely for the purpose of providing insurance to its parent constitutes insurance. Accordingly, as stated in the court's conclusion, an insurance agreement between parent and captive does not shift the parent's risk of loss and is not an agreement for "insurance." Premiums paid by the parent to the captive whether directly or through an unrelated insurer, may not be deducted by the parent as insurance premiums. See also, Carnation Co. v. Comm'r, 640 F.2d 1010 (9th Cir. 1981), where the court held there was no risk shifting or risk distribution with respect to the risks carried or retained by the parent's wholly-owned subsidiary.

In Malone & Hyde, Inc. v. Comm'r, T.C.M. 1989-604, rev'd and remanded, 62 F.3d 835 (6th Cir. 1995), the sixth circuit concluded that the captive insurer was a sham, and that the payments at issue were therefore not deductible as insurance premiums. The taxpayer and its operating subsidiaries purchased insurance from a commercial insurer, which then reinsured a significant portion of those risks with the taxpayer's captive insurance subsidiary. The commercial insurer retained a portion of the premiums received from the taxpayer and paid the remainder to the captive subsidiary as a reinsurance premium. The taxpayer claimed deductions for the insurance premiums paid to the commercial insurer.

In Rev. Rul. 2002-89; 2002-52 I.R.B. 984, the Service provided guidance on whether arrangements between a parent and a subsidiary insurance company qualified as an insurance arrangement and whether premiums paid were deductible under section 162 of the Code. Specifically, Situation 1 described a domestic corporation that entered into an annual arrangement with its wholly-owned insurance subsidiary. In doing so, the subsidiary either insures or reinsures the liability risks of the parent corporation. All business is maintained separately and the parent does not guarantee the subsidiary's risks. Also, 90 percent of the total premiums are received from the parent corporation on both a gross and net basis. The Service pointed out that when the total risk and liability coverage is more than 90 percent for the subsidiary; there is no risk shifting and risk distribution. Accordingly, the Service held that there was no insurance arrangement and that amounts paid by the parent to the subsidiary were not deductible under section 162.

Rev. Rul. 2002-90, 2002-52 I.R.B. 985, describes a holding company owning stock of 12 domestic subsidiaries. The holding company formed a wholly-owned insurance subsidiary to directly insure the liability risks of the 12 subsidiaries of the holding company. The 12 subsidiaries are charged arms-length premiums, which are established according to customary industry rating formulas. None of the operating subsidiaries have liability coverage for less than 5%, nor more than 15%, of the total risk insured by the wholly-owned insurance subsidiary. There are no parental (or other related party) guarantees of any kind, nor does the insurance subsidiary loan any funds to the holding company or to the 12 operating subsidiaries. The liability risks of the 12 subsidiaries are shifted to the insurance company. The premiums of the subsidiaries are pooled such that a loss by one operating subsidiary is borne, in substantial part, by the premiums paid by others. Therefore, the Service held that the arrangements between the insurance company and the 12 subsidiaries of the holding company constitute insurance.

ANALYSIS:

Based on the above information, we conclude that you are not an insurance company for federal income tax purposes. Our conclusion is based on two reasons. First, while neither the Code nor the regulations define the terms "insurance" or "insurance contract," the United States

Supreme Court has explained that for an arrangement to constitute insurance for federal income tax purposes both risk shifting and risk distribution must be present. Helvering v. LeGierse, 312 U.S. 531 (1941). Risk shifting occurs if a person facing the possibility of an economic loss resulting from the occurrence of an insurance risk transfers some or all of the financial consequences of the potential loss to the insurer. The effect of such a transfer is that a loss by the insured will not affect the insured because the loss is offset by the insurance payment. Risk distribution incorporates the "law of large numbers" to allow the insurer to reduce the possibility that a single costly claim will exceed the amount available to the insurer for the payment of such a claim. Clougherty Packing Co. v. Commissioner, 811 F. 2d 1297, 1300 (9th Cir. 1987). Risk distribution necessarily entails a pooling of premiums, so that a potential insured is not in significant part paying for its own risks. See Humana, Inc. v. Commissioner, 881 F.2d 247, 257 (6th Cir. 1989).

Since you have written only three income replacement contracts, one cosmetic medicine contract, and one aviation contract, we conclude that there was no risk distribution. Any claim paid on one of these contracts would be made in significant part from premiums paid by the purchaser of such contract. The so-called insured's loss would not be offset by the insurance payment, but would actually be more akin to a refund of the premium paid. Thus, the so-called insured would in significant part be paying for its own risk.

Moreover, with regard to the aviation contract, we conclude that the information supplied does not demonstrate that the insured has transferred to you an insurance risk which has been distributed. Since P is your owner and the owner of R (the entity that purchased the aviation contract), there is no distribution of risk between the two entities. To the contrary, such an arrangement lacks the requisite risk distribution to constitute insurance for federal tax purposes. See Rev. Rul. 2002-90, 2002-52 I.R.B. 985.

Second, even if we assume the income replacement and cosmetic medicine contracts are insurance (i.e., there is sufficient risk shifting and risk distribution), you were not primarily and predominantly in the business of issuing insurance contracts. Therefore, you were not an insurance company. In Inter-American Life Ins. Co. v. Commissioner, 56 T.C. 497 (1971), aff'd per curiam, 469 F.2d 697 (9th Cir. 1972), the issue before the court was whether the taxpayer was an insurance company. In that case, the taxpayer's shareholders formed the taxpayer for the ostensible purpose of reinsuring life insurance risks. During the years in issue, taxpayer did not maintain an active sales force, and although it initially secured a small amount of reinsurance business, its predominant source of income was from investments. The court concluded that the taxpayer's primary and predominant source of income was from investments and not from the insuring of risks. Further, the taxpayer's primary and predominant efforts were not expended in pursuit of its insurance activities. Accordingly, since the taxpayer did not use its capital and efforts for the purpose of earning income from the issuance of insurance, the taxpayer was not taxable as an insurance company. See also Cardinal Life Ins. Co. v. United States, 300 F. Supp. 387 (N.D. Tex. 1969); Industrial Life Ins. Co. v. United States, 344 F. Supp. 870 (D.S.C. 1972), aff'd per curiam, 481 F.2d 609 (4th Cir. 1973), cert. denied, 414 U.S. 1143 (1974).

For [redacted], your Form 990 shows $[redacted] in program service revenue, and a net gain from the sale of assets other than inventory of $x million. You sold, and reinsured only three income replacement contracts during tax year 2001. After reinsurance, your potential liability for these three contracts was less than $[redacted] The balance sheet included in your 2001 Form 990 shows savings and temporary cash investments of $[redacted] investment securities of $[redacted] and land, buildings, and equipment of $[redacted] Consequently, we conclude that your predominant source of income for 2001 is from investments, and thus, you were operated as an investment company rather than an insurance company in 2001.

For [redacted] your Form 990 shows only $[redacted] in program service revenue. While you had negative income from its investments, its balance sheet for 2002 shows that its investment in securities more than tripled from $[redacted] at the beginning of the year to $[redacted] at the end of the year. There is no evidence that you wrote any new contracts in 2002, and merely renewed the three income replacement contracts it had sold in 2001. Given these facts, we conclude that you did not use your capital and efforts for the purpose of earning income from the issuance of insurance in 2002. As in 2001, you were a corporation whose predominant activity was investing in 2002, and was not an insurance company for federal tax purposes. Because you operated as an insurance company for federal income tax purposes, you do not qualify for exemption under section 501(c)(15) of the Code.

Accordingly, you do not qualify for exemption as an organization described in section 501(c)(15) of the Code and you must 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 to this office, with a full explanation of your reasoning. This statement, signed by one of your officers, must be submitted within 30 days from 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.

If we do not hear from you within 30 days, this ruling will become final and a copy will be forwarded to the Ohio Tax Exempt and Government Entities (TE/GE) office. Thereafter, any questions about your federal income tax status should be directed to that office, either by calling 877-829-5500 (a toll free number) or sending correspondence to: Internal Revenue Service, TE/GE Customer Service, P.O. Box 2508, Cincinnati, OH 45201.

When sending additional letters to us with respect to this case, you will expedite their receipt by using the following address:

Internal Revenue Service

1111 Constitution Ave, N.W.
Washington, D.C. 20224

If you have any questions, please contact the person whose name and telephone number are shown in the heading of this letter.

Sincerely,

Robert C. Harper, Jr.
Manager, Exempt Organizations
Technical Group 3