Internal Revenue Service

Number: **200746003**
Release Date: 11/16/2007

Index Number: 831.00-00

Department of the Treasury
Washington, DC 20224

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Refer Reply To:
CC:FIP:B04
PLR-109008-07
Date:
August 10, 2007

Taxpayer:
Date:
State A:
Number 1:
B:
Company C:
Contract D:
Number 2:
Contract E:
Document F:
Contract G:

Document H:

Dear :

This letter is in response to the February 12, 2007 letter, as supplemented, from your ("Taxpayer") authorized representative requesting a ruling that Taxpayer does not qualify as an insurance company under § 831(c) of the Internal Revenue Code.

Facts

As represented by Taxpayer, Taxpayer was formed on Date under the captive insurance company laws of State A. Taxpayer is owned in equal proportion by Number 1 entities, which are classified as B under the Code. The Number 1 entities are exposed to risks with regard to property they own, which they insure through the commercial market. This coverage involves high per occurrence deductibles. Taxpayer was formed to achieve various objectives related to the owners' risk management functions. In particular, Taxpayer was formed to formalize the funding of deductibles (and possibly allow for higher retentions in future years) while allowing access to the reinsurance market and maximizing potential benefits under the Terrorism Risk Insurance Act. Taxpayer has contracted with Company C to provide management services.

On Date, Taxpayer issued two contracts. Contract D provides coverage for the deductible/self-insured retention under a specific commercial contract. Contract D covers only Number 2 of the Number 1 entities. Contract E provides coverage for all risks of direct physical loss or damage to property occurring during the policy period except as excluded. Contract E covers all of the Number 1 entities. Though the premium due is not divided equally between the Number 1 entities, the aggregate premium paid by the Number 1 entities exceeds the coverage limits, both per occurrence and aggregate.

Document F effects the operation of Taxpayer. It provides that with respect to Contracts D and E, the annual premium charged each participating entity will be actuarially determined based on that entity's actual loss experience. If losses and loss expenses, both paid and estimated, exceed the premium contribution of any other participating entity, the excess shall be shared according to a ratio of premium contribution of each participating entity to the total premium contributions of all participating entities.

Additionally, Taxpayer issued Contract G, which provides coverage for the deductible/self-insured retention with respect to certain risks. Contract G covers only Number 2 of the Number 1 entities. Though the premium due is not divided equally between the Number 2 of the Number 1 entities, the aggregate premium paid by the Number 2 of the Number 1 entities equals the coverage limits, both per occurrence and aggregate. Contract G implements a provision in Taxpayer's Document F whereby each the Number 1 entities may contribute to a 'fund' maintained by Taxpayer from which certain losses can be paid; as provided in both Document F and Contract G, the amount of the losses so paid is determined by a ratio of the claiming entity's valid claim(s) to the total value of all valid claims.

Document H governs the operation of Taxpayer. It provides that if one of the Number 1 entities fails to participate in one of Taxpayer's contracts for a stated number of consecutive years, that entity shall pay Taxpayer as liquidated damages for dissociation an amount not greater than the pro-rated premium based on the last year of participation that would have been satisfied had the entity participated in one of Taxpayer's contracts.

Almost all of Taxpayer's business activity is the issuance and administration of Contracts D, E, and G.

<u>Ruling Requested</u>

Taxpayer requests a ruling that it does not qualify as an insurance company under § 831(c) of the Code and should not be subject to tax under the provisions of part II of subchapter L of the Code.

Law and Analysis

Section 831(a) provides that taxes computed as provided in § 11 shall be imposed for each taxable year on the taxable income of every insurance company other than a life insurance company.

Section 831(c) provides that for purposes of § 831, the term "insurance company" has the meaning given to such term by § 816(a).

Section 816(a) provides that the term "insurance company" means any company more than half 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.

Neither the Code nor the regulations thereunder define the terms "insurance" or "insurance contract." The bedrock for evaluating whether an arrangement constitutes insurance is Helvering v. Le Gierse, 312 U.S. 531, 539 (1941), in which the Court stated that "historically and commonly insurance involves risk - shifting and risk - distributing" in "a transaction which involve[s] an actual 'insurance risk' at the time the transaction was executed." Insurance has been described as "involv[ing] a contract, whereby, for adequate consideration, one party agrees to indemnify another against loss arising from certain specified contingencies or perils…[I]t is contractual security against possible anticipated loss." Epmeir v. United States, 199 F.2d 508, 509-10 (7th Cir. 1952). Cases analyzing "captive insurance" arrangements have distilled the concept of "insurance" for federal income tax purposes to three elements, applied consistently with principles of federal income taxation:[1] 1) involvement of an insurance risk; 2) shifting and distribution of that risk; and 3) insurance in its commonly accepted sense. See, e.g., AMERCO, Inc. v. Commissioner, 979 F.2d 162, 164-65 (9th Cir. 1992), aff'g 96 T.C. 18 (1991).

The risk transferred must be risk of economic loss. Allied Fidelity Corp. v. Commissioner, 572 F.2d 1190, 1193 (7th Cir.), cert. denied, 439 U.S. 835 (1978). The risk must contemplate the fortuitous occurrence of a stated contingency, Commissioner v. Treganowan, 183 F.2d 288, 290-91 (2d Cir.), cert. denied, 340 U.S. 853 (1950) and must not be merely an investment risk. Le Gierse, 312 U.S. at 542; Rev. Rul. 89-96, 1989-2 C.B. 114.

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,

[1] These principles include respecting the separateness of corporate entities, the form and substance of the transaction(s), and the relationship between the parties. Sears, Roebuck and Co. v. Commissioner, 96 T.C. 61, 101-02 (1991), aff'd in part and rev'd in part, 972 F.2d 858 (7th Cir, 1992).

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 smooths out losses to match more closely its receipt of premiums. 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).

Rev. Rul. 2002-91, 2002-2 C.B. 991, addressed the situation where a number of entities ("members") joined to form a so-called "group captive" to provide insurance coverage for stated liability risks. Among other facts, no member owned more than 15% nor had more than 15% of the vote on any corporate governance issue of the group captive. No member's individual risk exceeded 15% of the total risk insured by the group captive. Moreover, no member had any obligation to pay additional premiums if that member's actual losses exceeded the premiums paid by that member. The Ruling holds the arrangement between the member and the group captive constitutes insurance and the group captive qualifies as an insurance company under § 831.

The arrangements issued by Taxpayer are distinct from that in Rev. Rul. 2002-91. The economic effect of Document F and Contracts E and G may be that each participating entity is in significant part paying for its own risks. Moreover, each of the Number 1 entities owns substantially more than 15% of the 'captive' as described in Rev. Rul. 2002-91; the Number 1 entities are significantly fewer than that the number implicitly involved in Rev. Rul. 2002-91, thereby negating risk distribution. Accordingly, Contracts D, E, and G do not constitute insurance for federal income tax purposes. If, as represented, these contracts are more than half the business of Taxpayer during the taxable year, Taxpayer will not qualify as an insurance company under § 831(c) and therefore is not subject to tax under § 831(a).

Ruling

Provided more than half of its business during the taxable year is issuing Contracts D, E, and G (which are contracts that do not constitute insurance for federal income tax purposes), Taxpayer does not qualify as an insurance company under § 831(c) of the Code and is not subject to tax under the provisions of part II of subchapter L of the Code.

Except as expressly provided herein, no opinion is expressed or implied concerning the tax consequences of any aspect of any transaction or item discussed or referenced in this letter.

This ruling is directed only to Taxpayer. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

In accordance with the Power of Attorney on file with this office, a copy of this letter is being sent to Taxpayer's authorized representatives.

A copy of this letter must be attached to any income tax return to which it is relevant. Alternatively, for a return(s) filed electronically this requirement is satisfied by attaching a statement to the return(s) that provides the date and control number of the letter ruling.

The ruling contained in this letter is based upon information and representations submitted by Taxpayer and accompanied by a penalty of perjury statement executed by an appropriate party. While this office has not verified any of the material submitted in support of the request for rulings, it is subject to verification on examination.

Sincerely,

Donald J. Drees, Jr.
Senior Technician Reviewer
Branch 4