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Department of the Treasury
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Person To Contact:
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CC:FIP:B04
PLR-117007-08

Date:
September 8, 2008

LEGEND

Taxpayer =

Obligor =

State X =

State Y =

B =

Date A =

Dear :

This is in response to a ruling request, dated March 12, 2008, and supplementary submissions, submitted by your authorized representatives, concerning a wholly-owned captive insurance subsidiary Newco, which is domiciled in State Y, that will insure certain insurance risks of Taxpayer, which is domiciled in State X, and its affiliates. Your letter requests that the extended service contracts reinsured by Newco under the reinsurance contract with Obligor constitute a pool of unrelated insurance risk for

Federal tax purposes and that Newco will qualify as an insurance company within the meaning of section 831(a) of the Internal Revenue Code.

Taxpayer is incorporated under the laws of State X and is headquartered in that State. Taxpayer is the parent of an affiliated group that files a consolidated federal income tax return. Newco will insure certain insurance risks of Taxpayer and will reinsure a 90 %-100% quota share of the risks on extended service contracts issued by Obligor, a wholly-owned subsidiary of Taxpayer. Newco will be capitalized with B dollars. Obligor anticipates selling a substantial volume of extended service contracts, based on Taxpayer's historical sales volume. In a previously issued letter of Date A Obligor has been determined to qualify as an insurance company under the provisions of section 831(a) of the Code. Newco will serve to centralize the risk management and administrative functions associated with the issuance of insurance policies. Newco represents that it's only business activity will be the issuance of direct insurance policies and the reinsurance polices. Newco represents that the direct policies will be offered to Taxpayer and its affiliates. The premium charged for the reinsurance will be for an arms length consideration. The reinsurance will constitute more than half of the total premiums collected by Newco.

LAW AND ANALYSIS

Section 831(a) of the Code provides that taxes, as computed under §11, will be imposed for each taxable year on the taxable income (as defined by § 832) of each insurance company other than a life insurance company.

Section 831(c) defines the term "insurance company," for purposes of §831, as having the same meaning as the term given under § 816(a).

Section 816(a) provides that the 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.

Section 1.831-3(a) of the income Tax Regulations provides that for purposes of §§ 831 and 832, the term "insurance company" means only those companies that qualify as insurance companies under the definition of former § 1.810-1(b) (now §1.801-3(a)(1)).

Section 1.801-3(a)(1) provides that although the company's name, charter powers, and subjection to state insurance laws are significant in determining the business that a company is authorized and intends to carry on, it is the character of the business actually done in the taxable year that determines whether the company is taxable as an insurance company under the Internal Revenue Code. See also, Bowers v. Lawyers' Mortgage Co., 285 U.S. 182, 188 (1932) (to the same effect as the

regulation). To qualify as an insurance company, a taxpayer "must use its capital and efforts primarily in earning income from the issuance of contracts of insurance." Indus. Life Ins. v. United States, 344 F. Supp 870,877 (D.S.C. 1972), aff'd per curiam, 481 F.2d 609 (4th Cir. 1973), cert. Denied, 414 U.S. 1143 (1974). To determine whether a taxpayer qualifies as an insurance company, all relevant facts will be considered, including but not limited to, the size and activities of its staff, whether it engages in other trades or businesses, and its sources of income. See generally, Bowers, 285 U.S. 182, Indus. Life Ins. Co. at 875-77; Inter-Am. Life Inc. Co. v. Commissioner, 56 T.C. 497, 506-08 (1971), aff'd per curiam, 469 F 2d 697 (9th Cir. 1971).

Neither the Code nor the regulations thereunder define the term "insurance" or "insurance contract." The accepted definition of "insurance for Federal income tax purposes relates back to Helvering v. Le Gierse, 312 U.S. 531, 539 (1941), in which the Supreme Court stated the "[h]istorically 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 "involve[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 a contractual security against possible anticipated loss." Epmeier v. United States 199 F.2d 508, 509-510 (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) involvement of an insurance risk; 2) shifting and distribution of that risk; and 3) insurance in its commonly accepted sense. See e.g., AMERICO, Inc. v. Commissioner, 979 F.2d 162, 164-165 (9th Cir. 1992), aff'g 96 T.C. 18 (1981).

Risk shifting occurs if a person facing the possibility of an economic loss transfer some or all of the financial consequences of the potential loss to the insurer. See Rev. Rul. 92-93, 1992-2 C.B. 45 (when parent corporation purchased a group-term life insurance policy from its wholly owned insurance subsidiary, the arrangement was not held to be "self-insurance" because the risks of economic loss was not that of the parent), modified on other grounds, Rev. Rul. 2001-31, 2001-1 C. B. 1348. If the insured has shifted its risk to the insurer, then a loss by the insured does not affect the insured because the loss is offset by the insurance payment. See Clougherty Packing Co. v. Commissioner, 811 F.2d 1297, 1300 (9th Cir. 1987).

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 as premiums and set aside for the payment of such claim. Insuring many independent risks in return for numerous premiums serves to distribute risk. By assuming numerous, relatively small, independent risks that occur randomly over tine, the insurer can smooth out losses to match more closely its receipt of premiums. See Clougherty Packing Co.v. Commissioner, 811 F.2d at 1300.

The "commonly accepted sense" of insurance derives from all the facts surrounding each case, with emphasis on comparing the implementation of the arrangement with that know to be insurance. Court opinions identify several nonexclusive factors bearing on this, such as the treatment of an arrangement under the applicable state law, AMERCO, 96 T.C. at 41; the adequacy of the insurer's capitalization and utilization of premiums priced at arm's length, The Harper Group v. Commissioner, 96 T.C. 45, 60 (1991), aff'd, 979 F. 2d 1341 (9th Cir. 1992); separately maintained funds to pay claims, Ocean Drilling & Exploration Co. v. United States, 24 Cl. Ct. 714, 728 (1991), aff'd per curiam, 988 F.2d 1135 (Fed Cir. 1993); and the language of the operative agreements and the method of resolving claims, Kidde Indus. Inc. v. United States, 49 Fed. Cl. 42, 51-52 (1997).

Not all transactions which involve shifting and distributing an element of insurance risk qualify as insurance. Rev. Rul. 68-27, 1968-1 C.B. 315, holds that an arrangement whereby an organization issued medical service contracts to various groups and individuals who prepaid the contract price at fixed monthly rates does not qualify as an insurance contract for purposes of the Code because the risk assumed by the issuer with regard to the therapeutic care is predominately a normal business risk because the "organization generally does not incur any expense other than that which it incurs in providing the medical services through a salaried staff of physicians, nurses, and technicians." See also, Johnson v. Commissioner, 108 T.C. 448, 474 n7 (1997) aff'd in part and rev'd in part, 184 F.3d 786 8th Cir.1999).

In Rev. Rul. 80-95, 1980-1 C.B. 252, an employer obtained coverage for its obligations under long-term disability benefits it promised its employees. The risk involved was the employees' risk of loss from injury. The indemnifier was not directly liable to any individual employee. The ruling concluded that the indemnification agreement was a contract of sickness or accident insurance under § 4372(e) because the risk assumed by the indemnifier had the same character as that borne by the employer: injury to an employee. Whether the disability benefit plan qualified as insurance for federal income tax purposes was not dispositive.

In considering whether risk has been shifted, it is important to recognize that interrelated contracts must be considered together. LeGeirse, 312 U.S. 540. See also Clougherty Packing Co., 811 F.2d at 1301("Where separate agreements are interdependent , they must be considered together so that their overall economic affect can be assessed.")

The holding in Rev. Rul. 80-95 recognized that the economic substance of the arrangement notwithstanding the suggestion that the plan was not insurance and that the employer did not qualify as an insurance company for federal income tax purposes. The substance of the arrangement was that the employees' risk of loss from injury was shifted and distributed.

Similarly to Rev. Rul. 80-95, the arrangement between Newco and Obligor has economic substance to provide for the insurance risk covered under extended service contracts offered by Obligor to unrelated parties. The risk of loss is shifted to Newco and is distributed among the large number of unrelated purchasers of Taxpayer's products.

CONCLUSION

Based on the information submitted, we conclude that, in its initial taxable year, and in each taxable year that the facts are similar, that the extended service contracts reinsured by Newco under the reinsurance contract with Obligor constitute a pool of unrelated insurance risks for U.S. Federal tax purposes and that Newco will qualify as an insurance company within the meaning of section 831(a) of the Internal Revenue 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 the taxpayer requesting it. Section 6110(k)(3) 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 your authorized representative.

Sincerely,

/S/

Donald J. Drees, Jr.
Senior Technician Reviewer, Branch 4
(Financial Institutions & Products)