TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

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

Release Number **200952061**
Release Date: 12/24/09
Date: 09/28/2009

UIL: 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 as an organization described in Internal Revenue Code section 501(c)(15). Recently, we sent you a letter in response to your application that proposed an adverse determination. The letter explained the facts, law and rationale, and gave you 30 days to file a protest. Since we did not receive a protest within the requisite 30 days, the proposed adverse determination is now final.

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,

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: 05/29/2009

Contact Person:

Identification Number:

Contact Number:

UIL: 501.15-00

FAX Number:

Employer Identification Number:

Legend:

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Dear

We have considered your application for recognition of exemption from Federal Income tax under Internal Revenue Code section 501(a). Based on the information provided, we have concluded that you do not qualify for exemption under section 501(c)(15) of the Code. This

letter supersedes our letter to you dated December 12, 2006.

Facts:

You were incorporated outside of the United States in D. You are a stock corporation owned by A. A and B are your directors, and are related to each other. In E, you filed for an election under section 953 of the Code to be taxed as a domestic corporation.

You are a provider of first dollar coverage (primarily property) to persons and entities related to C and/or certain members of A's family. C is a commercial corporation primarily engaged in building and leasing apartments for use as multiple family dwellings. C is owned by A and B. C is the general partner in various limited partnerships insured by you. A, B and related entities controlled by A hold varying interests in LLCs that are insured by you.

Initially, you issued a single policy, which had two types of insurance coverage, Insuring Agreement A and Insuring Agreement B. On J, a second policy was issued. Under the two policies, you insured at any one time anywhere from 6 to 10 entities, in which C was general partner or that were LLCs, in which A, B and related entities of A and B controlled. The entities you insured on the first policy are all in the same geographic locale. The entity that was issued the second policy is in a geographic locale which is separate from the entities you insured on the first policy.

Insuring Agreement A provided first dollar coverage for All Risk Form perils, including flood and wind and earthquake for property damage and time element per property per year. However, Insuring Agreement A covered only flood and wind storms that receive a "Name" designation by the National Weather Service.

Insuring Agreement B provided coverage for more common perils. Insuring Agreement B had a $25,000 loss per location limit and a maximum of $150,000 loss on all locations.

In F, the premiums assigned to the limited partnerships controlled by C as general partner represent slightly more than mm% of the total premiums assigned to all entities. A related LLC of C is assigned nn% of total premiums and another LLC related to C is assigned pp% of total premiums. These percentages represent m% of your total premiums. The two insureds with the highest risk had p% of your total risk.

For G, the premiums assigned to limited partnerships controlled by C as general partner amounted to w% of total premiums. C and two other related LLCs also related to C had vv% of total premiums. The two insureds with the highest risk had ww% of the total risk.

For H, the total premiums assigned to limited partnerships controlled by C as general partner amounted to qq%. Premiums attributed to two other related LLCs amounted to nn% and ss%. Therefore, tt% of all premiums emanated from three related sources, and the two insureds with the highest amount of risk had o% of the total risk.

For I, the total premiums assigned to limited partnerships controlled by C as general partner amounted to v% of your total premiums. Two other LLCs in which A and B had controlling interests were assigned cc% and dd% of the total premiums. Thus, yy% of your premiums emanated from only three sources, and two insureds with the highest risk had zz% of total risk.

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. For years after December 31, 2003, the law has been amended stating gross receipts can total $600,000 and premium income must be at least 50% of total gross receipts.

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.

Neither the Code nor the regulations define the terms "insurance" or "insurance contract." 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. Commissioner, 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. 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).

In Rev. Rul. 60-275, 1960-2 C.B. 43, a contract carrier transported automobiles from an automobile assembly plant to land it leased on which it stored these vehicles and other

equipment. The land was bounded by a river which exposed the stored property and leasehold improvements to possible flood damage. Under an agreement with a reciprocal flood insurance exchange, the carrier corporation and others subject to the same flood risk made annual payments for a specified period for flood damage coverage. The revenue ruling pointed to this scenario as a situation that lacked independence of the risks necessary for risk distribution. The Service concluded that risk shifting was not present in this reciprocal flood insurance arrangement based on the idea that a major flood would likely affect all properties in a particular flood basin so that there was little likelihood that the subscribers would share any risk.

Rev. Rul. 2002-89, 2002-2 C.B. 984, Situation 1, held that an arrangement between related entities did not constitute insurance. A domestic corporation entered into an annual arrangement with its wholly-owned insurance subsidiary to either insure or reinsure the liability risks of the parent corporation. The premiums that the subsidiary earns from its arrangement with the parent constitute 90% of its total premiums earned during the taxable year on both a gross and a net basis. The liability coverage that the subsidiary provides to the parent accounts for 90% of the total risks borne by the subsidiary. The ruling states that no court has treated such an arrangement between a parent and its wholly-owned subsidiary as insurance. To the contrary, the arrangement lacks the requisite risk shifting and risk distribution to constitute insurance for federal income tax purposes.

In Rev. Rul. 2002-90, 2002-2 C.B. 985, S, a wholly-owned insurance subsidiary of P, directly insured the professional liability risks of 12 operating subsidiaries of its parent. S was adequately capitalized; there were not related guarantees of any kind in favor of S; perhaps most importantly, S and the insured operating subsidiaries conducted themselves in a manner consistent with the standards applicable to an insurance arrangement between unrelated parties. None of the operating subsidiaries had liability coverage for less than 5%, nor more than 15% of the total risk insured by S. Together, the 12 operating subsidiaries had a significant volume of independent homogenous risks. Under the facts presented, the ruling concludes the arrangements between S and each of the 12 operating subsidiaries of S's parent constitute insurance for federal income tax purposes.

In Rev. Rul. 2005-40, 2005-2 C.B. 4, considered X, a domestic corporation, which operated a courier transport business under the following situations, (1) its own name (i.e., as a sole proprietorship), (3) through 12 LLCs of which X is a single member and which were disregarded as entities separate from X under the Procedure and Administration Regulations, or (4) through 12 LLCs of which X is a single member and which had elected to be classified as associations. In each situation, X (or the LLCs) entered into an arrangement with Y to cover an insurance risk; the arrangement was Y's only such arrangement. In situations (3) and (4), none of the LLCs accounts for less than 5%, or more than 15%, of the total risk assumed by Y. The ruling holds that, where X conducted the business in its own name or through the disregarded LLCs, the arrangement did not constitute insurance for federal income tax purposes for lack of risk distribution; the arrangement did constitute insurance for federal income tax purposes in the situation where X conducted the business through LLCs which had elected to be classified as associations because the LLCs could now be treated as separate insureds resulting in risk distribution.

Analysis:

Based on the above information, we conclude that you have not demonstrated that an insurance risk was distributed. Accordingly, we conclude that your activity of providing first dollar insurance coverage to A, B, C and its related entities does not constitute insurance for federal income tax purposes. Because this is your only activity, we conclude that you are not an insurance company for federal income tax purposes. Therefore, since you are not an insurance company for federal income tax purposes, you do not qualify for exemption under section 501(c)(15) of the Code.

In reaching our conclusion, you have not shown that there is sufficient risk distribution among the insureds under the insurance agreements. In order to make this determination, it is necessary to establish how many insureds there are under the arrangement and the amount of risk shifted to you. See *Clougherty Packing* and *Humana* discussed above.

You have provided first dollar insurance coverage to various limited partnerships and LLCs. In determining the insureds in a limited partnership, the general partner is exposed to liability in excess of the partnership assets; particularly with regard to liability risks, the general partner is vulnerable to lose more than its equity in the partnership. Accordingly, it is appropriate to view the general partner as being the insured. See section 404(a) of the Uniform Limited Partnership Act.

As with corporations, because the exposure to liability of any member of a multimember LLC is limited to that member's equity interest in the company, it is appropriate to view the company as being the insured. See section 304(a) of the Uniform Limited Liability Company Act.

The Service has taken the position that insurance exists where 12 insureds each contributed between 5% and 15% to the insurer's total risks. See Rev. Rul. 2002-90. Insurance also exists where 12 LLCs, that elected to be classified as associations, had each contributed between 5% and 15% of the insurer's total risks. See Rev. Rul. 2005-40, situation 4. However, see situation 1 Rev. Rul. 2005-40, where a single insured was not able to provide an adequate premium pooling base for insurance to exist.

In your situation, C is the insured with respect to the limited partnerships that are insured, because it is the general partner. See section 404(a) of the Uniform Limited Partnership Act. Additionally, all LLCs related to A, B, and C are separate and independent insureds. See section 304(a) of the Uniform Limited Liability Company Act.

You are not similar to the organization described in Rev. Rul. 2002-90, because the risk in Rev. Rul. 2002-90 was with a significant volume of independent, homogenous risks between 5% and

15%, and, in your situation, a heavy concentration of risk has been with two to three insureds per year in excess of 15%. In F, two insureds had p% of the total risk, and three insureds had m%. In G, two insureds had ww% of the total risk, and three insureds had vv%. In H, two insureds had o% of the total risk, and three insureds had tt%. In I, two insureds had zz% of the total risk, and three insureds had yy%. Therefore, such concentration of risk does not allow the insurer to reduce the possibility that a single costly claim will not exceed the amount of premiums taken in from such a limited number of insureds to conclude that insurance exists.

You are similar to the organization described in Rev. Rul. 60-275 because there is no independence of risks necessary for risk distribution since all but one of the insured entities are in one geographic locale. There is little likelihood of any risk sharing, and thus no insurance as described in section 501(c)(15).

You have the right to file a protest if you believe this determination is incorrect. To protest, you must submit a statement of your views and fully explain your reasoning. You must submit the statement, signed by one of your officers, within 30 days from the date of this letter. We will consider your statement and decide if the information affects our determination.

Your protest statement should be accompanied by the following declaration:

> *Under penalties of perjury, I declare that I have examined this protest statement, including accompanying documents, and, to the best of my knowledge and belief, the statement contains all the relevant facts, and such facts are true, correct, and complete.*

You also have a right to request a conference to discuss your protest. This request should be made when you file your protest statement. An attorney, certified public accountant, or an individual enrolled to practice before the Internal Revenue Service may represent you. If you want representation during the conference procedures, you must file a proper power of attorney, Form 2848, *Power of Attorney and Declaration of Representative,* if you have not already done so. For more information about representation, see Publication 947, *Practice before the IRS and Power of Attorney.* All forms and publications mentioned in this letter can be found at www.irs.gov, Forms and Publications.

If you do not intend to protest this determination, you do not need to take any further action. If we do not hear from you within 30 days, we will issue a final adverse determination letter. That letter will provide information about filing tax returns and other matters.

Please send your protest statement, Form 2848 and any supporting documents to this address:

Internal Revenue Service
SE:T:EO:RA:T:3, PE-3L7
Attn:
1111 Constitution Ave, N.W.
Washington, DC 20224

You may also fax your statement using the fax number shown in the heading of this letter. If you fax your statement, please call the person identified in the heading of this letter to confirm that he or she received your fax.

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

Sincerely,

Director, Exempt Organizations
Rulings & Agreements