**Internal Revenue Service**

Department of the Treasury
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Date:
April 16, 2010

In Re:

Legend

Company =

Lead Company =

Foreign Country M =

2 =

Individual A =

Individual B =

Sole Proprietorship =

Trust =

Date A =

Y =

Year C =
Number a =

Number b =

Number c =

Number d =

Number e =

Number f =

Independent Insurer 1 =

Independent Insurer 2 =

Independent Insurer 3 =

Independent Insurer 4 =

Independent Insurer 5 =

Dear

This is in response to the letter submitted by Company dated May 12, 2008, primarily requesting a ruling under § 831 relating to Company's status as an insurance company for federal income tax purposes.

FACTS

Company was incorporated in Foreign Country M on Date A. Company has been licensed by the Insurance Regulators of Foreign County M as a Class 2 Association Insurance Company effective for Year C. Also effective for Year C, Company has made an election under § 953(d) to be taxed as a domestic corporation. All of the stock of

Company is owned by Trust; in turn, Individual A and Individual B are each Number a % beneficial owners of Trust. Individual B is the spouse of Individual A.

Sole Proprietorship is the Y professional practice of Individual A, the income and expenses of which are reported on the joint federal income tax return of Individual A and B.

Company issues to Sole Proprietorship contracts which cover insurance risks: (1) capital asset (output) coverage,[1] (2) employment related practices liability coverage, (3) executive liability coverage, and (4) commercial crime coverage. Company is responsible for the issuance of contracts, billing premiums and claims processing with respect to its insured.

Company participates in a pool operated by Lead Company, incorporated and licensed as an insurance company in Foreign Country M. The pool consists of Number b independent entities in addition to Company. All participants in the pool issue contracts by which for consideration they provide coverage for certain insurance risks. They use recognized actuarial techniques, based, in part, on commercial rates for similar coverage, to determine the consideration to be charged.[2] The aggregate number of other entities which are covered by the participants on a per line of business basis is at least Number d and as many a Number e. Each participant conducts no business other than the issuing and administering the contracts described herein.

Company receives consideration for the coverage it provides to Sole Proprietorship. Under "Coinsurance Agreement A" (an automatic pro rata indemnity reinsurance treaty) it contributes all of this consideration on each line it insures to the pool. Further, using "Coinsurance Agreement B" (another automatic pro rata indemnity reinsurance agreement) Company will then receive a quota share of the aggregate consideration contributed to the pool which is equivalent in dollar terms to Number f % of the amount it contributed to the pool for each line of coverage. Under Coinsurance Agreement B, Company (in its role as a reinsurer) is liable for its pro rata share of the claims which are incurred and reported during the accounting period.[3]

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[1] This contract is a package policy that contains coverage for buildings, business personal property, business income and extra expense, legal defense and other business related coverage. Further, the capital asset (output) policy issued to Sole Proprietorship contained a number of additional endorsements including professional liability business interruption and excess professional liability legal claim expenses.

[2] More specifically, the pricing of the contracts is based on an actuarial model that is published by the Insurance Services Office and the results of that model are compared with available market based pricing from other insurance companies.

[3] Incurred Claims means (a) paid claims, plus, (b) ceded outstanding claim reserves and (including present value reserves on continuing, unreported and reported but unpaid claims, and a claim liability for claims in course of settlement and for incurred but not reported claims), less (c) ceded outstanding claims and liabilities as of the end of the previous accounting period.

No entity covered by a participant has any obligation to pay any additional consideration if that entity's actual losses during any period of coverage exceed the consideration paid. Consideration paid by any covered entity may be used to satisfy claims of the other covered entities. No entity that terminates its coverage is required to make additional contributions to a participant to cover losses in excess of the consideration paid. Company, Lead Company, or any of the other participants in the pool are not related.

As a result of Company's participation in the pool, the net consideration received by Company will, generally, have the following characteristics on each line of coverage it provides: (1) through the other participants, Company will, thus, assume (in total) risks from no less than Number d and as many as Number f independent entities in any line of coverage, and (2) through operation of the pool, all of the covered entities, including Sole Proprietorship, will account for no more than 15% of the total risks assumed by Company. Also, it is represented that there are no guarantees of Company's obligations by Trust, Individuals A or B, or any other related person. In addition, Company represents that that it is well capitalized and does not provide any shareholder loans.

LAW AND ANALYSIS

Section 831(a) of the Internal Revenue Code provides that taxes, computed as provided in § 11, are imposed for each taxable year on the taxable income of each 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). Under § 816(a), 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."

Neither the Code nor the regulations define the terms "insurance" or "insurance contract" in the context of property and casualty insurance. The Supreme Court of the United States 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). The risk transferred must be risk of economic loss. Allied Fidelity Corp. v. Commissioner, 572 F.2d 1190, 1193 (7th Cir. 1978). The risk must contemplate the fortuitous occurrence of a stated contingency, Commissioner v. Treganowan, 183 F.2d 288, 290-291 (2d Cir. 1950), and must not be merely an investment or business risk. Rev. Rul. 2007-47, 2007-2 C.B. 127. In addition, the arrangement must constitute insurance in the commonly accepted sense. See, e.g., Ocean Drilling & Exploration Co. v. United States, 988 F.2d 1135, 1153 (Fed. Cir. 1993); AMERCO, Inc. v. Commissioner, 979 F.2d 162 (9th Cir. 1992).

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 a payment from the insurer. 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).

Courts have recognized that risk distribution necessarily entails a pooling of premiums, so that a potential insured is not in significant part paying for its own risks. Humana, Inc. v. Commissioner, 881 F.2d 247, 257 (6th Cir. 1989). See also Ocean Drilling and Exploration Co., 988 F.2d at 1153 ("Risk distribution involves spreading the risk of loss among policyholders."); Beech Aircraft Corp. v. United States, 797 F.2d 920, 922 (10th Cir. 1986) ("[R]isk distributing means that the party assuming the risk distributes his potential liability, in part, among others.") On the other hand, a purported insurance arrangement where an issuer who contracts with only one policyholder and retains the risk under such contract does not qualify as an insurance contract for federal income tax purposes. See Rev. Rul. 2005-40, 2005-2 C.B. 4.

Rev. Rul. 2002-89, 2002-2 C.B. 984, set forth circumstances under which arrangements between a domestic parent corporation and its wholly owned subsidiary constitute insurance and explained that a parent/wholly owned subsidiary arrangement does not constitute insurance if the parent accounts for 90% of the risk, but does if other insureds constitute more than 50% of the risk.

Rev. Rul. 2002-90, 2002-2 C.B. 985, holds that an arrangement between a licensed insurance subsidiary of parent, and each of 12 of parent's operating subsidiaries where, *inter alia*, no one subsidiary accounts for less than 5% nor more than 15% of the total risk insured by the insurance subsidiary constitutes insurance.

Rev. Rul. 2002-91, 2002-2 C.B. 991, holds that an arrangement involving a group of unrelated businesses of which, *inter alia*, none accounted for more than 15% of the total insured risk constitutes insurance.

Rev. Rul. 2005-40, applies the principles of Rev. Ruls. 2002-89 and 2002-90 to situations involving corporations and single-member limited liability companies.

As pointed out in the law background of Rev. Rul. 2009-26, 2009-38 I.R.B. 366, the Internal Revenue Code of 1986 and administrative guidance treat reinsurance in a manner similar to direct insurance for many purposes; for example, both direct

insurance and reinsurance business may qualify a taxpayer as an insurance company under section 816(a) or 831(c), as applicable.[4]

In Alinco Life Insurance Co. v. United States, 373 F.2d 336 (Ct Cl. 1967), a large finance company formed a wholly-owned subsidiary corporation (Alinco), which qualified as a life insurance company under the laws of Indiana. Customers of the finance company (borrowers) purchased credit life insurance from an unrelated insurance company, which in turn reinsured a fixed proportion of those contracts with Alinco. Even through Alinco reinsured risks underwritten by only one insurance company, those risks aggregated nearly one billion dollars of business, with a large number of customers, for which Alinco was required by the state insurance department to maintain reserves. Interpreting regulatory language that was identical to what now appears in § 816(a), the court concluded that Alinco was in the business of "reinsuring risks" underwritten by insurance companies.

Section 162(a) of the Code provides, in part, that there shall be allowed as a deduction all of the ordinary and necessary expenses paid or incurred during the taxable year in carrying on a trade or business.

Section 1.162-1(a) of the Income Tax Regulations provides, in part, that among the items included in business expenses are insurance premiums against fire, storms, theft, accident, or other similar losses in the case of a business.

In the present situation, under Coinsurance Agreement A Company contributes all of its direct consideration and associated risks to the pool and, under Coinsurance Agreement B, Company receives a quota share of the consideration and associated risks from the pool equal in dollar terms to Number f % of the amount Company ceded to the pool on each line of coverage. The result is that there are a sufficient number of unrelated covered entities such that none is paying for a significant portion of its own risks. Accordingly, given that insurance risks are covered, the arrangement achieves adequate risk shifting and risk distribution such that the contracts issued by Company constitute insurance for federal income tax purposes. For the year for which the predicate facts were represented, this appears to be more than half of Company's business.

CONCLUSION

Based solely on the information submitted and the representations made, and provided that Company is adequately capitalized and continues to operate as a participant in the pool (in the manner described above), we conclude that the arrangement between the Sole Proprietorship and Company constitutes insurance for federal income tax

[4] On the other hand, section 845 which grants to the Secretary explicit authority to reallocate, recharacterize, or make other adjustments with respect to certain reinsurance arrangements does not refer to direct insurance.

purposes, such that consideration paid by Sole Proprietorship to Company is an insurance premium under § 1.162-1(a) of the Income Tax Regulations, and Company would qualify under part II of subchapter L for the taxable year if it were a domestic corporation.

Except as expressly provided herein, no opinion is expressed in this letter ruling under the provisions of any other section of the Code or Regulation. No opinion is expressed as to whether or not the amount of premiums charged by Company has been calculated correctly or whether other requirements under § 162 have been met. See e.g. , Rev. Rul. 2007-3, 2007-1 C.B. 350. Further, no opinion has been requested and none has been expressed as to whether the pool is an entity for federal income tax purposes, or as to the classification of any other participant or the treatment of any arrangement involving any other participant. This ruling letter is directed only to the taxpayer who requested it. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

A copy of this letter should be attached to any Federal income tax return to which it is relevant.

In accordance with the power of attorney on file in this office, we are sending a copy of this letter to your authorized representative.

Sincerely yours,

/S/

JOHN E. GLOVER
Senior Counsel, Branch 4
Office of the Associate Chief Counsel
(Financial Institutions & Products)