Internal Revenue Service

Department of the Treasury
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Date:
February 29, 2012

In re:

Legend

Company	=
Foreign Country N	=
N	=
Individual A	=
Date A	=
Year B	=
C	=
D	=
E	=
F	=
G	=
Foreign Country H	=
Number I	=

Number J =

Number K =

P =

x =

Insured Sole Proprietorship =

Insured Corporation 1 =

Insured Corporation 2 =

Insured Corporation 3 =

Insured Corporation 4 =

Insured Corporation 5 =

Insured Entity 6 =

Independent Insurer 1 =

Independent Insurer 2 =

Independent Insurer 3 =

Independent Insurer 4 =

Independent Insurer 5 =

Independent Insurer 6 =

Independent Insurer 7 =

Independent Insurer 8 =

Independent Insurer 9 =

Independent Insurer 10 =

Independent Insurer 11 =

Independent Insurer 12 =

Independent Insurer 13 =

Independent Insurer 14 =

Dear :

This is in response to the letter submitted by Company dated September 12, 2011, primarily requesting a ruling under § 831 relating to Company's status as an insurance company for federal income tax purposes. Additional information was provided in correspondence dated December 6, 2011, January 11, 19, 20 and 25, 2012.

FACTS

Company was incorporated in Foreign Country N on Date A. Company has been licensed by the Insurance Regulators of Foreign County N as a General Insurance Captive effective for Year B. Also effective for Year B, Company has made an election under § 953(d) to be taxed as a domestic corporation. The stock of Company is owned 100 percent by Individual A.

Insured Sole Proprietorship is the personal E surgery and F practice of Individual A. Individual A is the sole owner of the proprietorship.[1]

Insured Corporation 1 owns the patent rights and all licensing rights to a C medical appliance developed by Individual A. All of the stock of Insured Corporation 1 is owned by Individual A.

Insured Corporation 2 operates D labs and performs its own billing to insurance plans and collects co-pays and deductibles from patients covered by a plan. All of the interests in Insured Entity 2 are owned by Individual A.

Insured Corporation 3 performs all hiring, staffing, and training as well as all out of plan billing. All of the stock of Insured Corporation 3 is owned by Individual A.

Insured Corporation 4 doing business as G currently performs all United States assembly of sub-components manufactured in Foreign Country H. All of the stock of Insured Corporation 4 is owned by Individual A.

Insured Corporation 5 is engaged in marketing and providing customer support to affiliated doctors offices who perform the C medical appliance procedure and use Individual A's C medical appliance. All of the stock of Insured Corporation 5 is owned by Individual A.

Company offers the Insured Sole Proprietorship, Insured Corporations and Insured Entity 6 the following four types of contracts: (1) P policy, (2) employment related practices liability policy, (3) executive liability policy, and (4) commercial crime policy.

The most significant policy is the P policy. This policy is a package policy that contains coverage for buildings, business personal property, business income and extra expense, legal defense and other business related coverages. The employment-related practices liability policy provides coverage for liability arising out of claims for injury to an employee because of an employment-related offence, as well as a duty to defend. The executive liability coverage policy provides two coverages: one applies to liability arising out of claims for wrongful acts or interrelated wrongful acts committed by the named company's directors or officers, the other is a corporate reimbursement coverage that applies to claims for which the named company is legally obligated to indemnify its directors or officers when such claims involve wrongful acts or interrelated wrongful acts committed by them. The commercial crime policy covers business losses

[1] Insured Entity 6 manufactures the C medical appliance in Foreign Country H and performs warehousing and distribution in the United States. All of the interests in Insured Entity 6 are owned by Individual A. Insured Entity 6 is a disregarded entity for federal income tax purposes and its income and expenses will be reported on a Schedule C (Profit or Loss From Business) of the Form 1040 (U.S. Individual Income Tax Return) of Individual A.

due to employee theft of money, securities, other property of the insured, including client's property on the client's premises.

In order to assist in achieving its overall risk distribution, Company participates in a reinsurance pool consisting of Number I independent insurers (Independent Insurers 1 through 14) in addition to Company. These other insurers and their insureds are unrelated to Company and Company's insureds (Insured Sole Proprietorship, Insured Corporations 1 through 5 and Insured Entity 6). Thus, while Company, as a direct writer, receives premiums from its insurers under Coinsurance Agreement A (a pro rata indemnity reinsurance treaty) it cedes Number J percent of these directly written premiums on each line it insures to the reinsurance pool. Further, using Coinsurance Agreement B (another pro rata indemnity reinsurance agreement), Company will then assume a quota share of the premiums from the reinsurance pool which is roughly equivalent in dollar terms to the amount it ceded on each line of insurance.[2]

The following applies to all of the insurers participating in the reinsurance pool:

All insurers issue insurance contracts and charge premiums for the insurance coverage provided under their respective insurance contracts. All insurers use recognized actuarial techniques, based, in part, on commercial rates for similar coverage, to determine the premiums charged to an individual insured.

Each of the insurers pools all the premiums it receives in its general funds and pays claims out of those funds. Each insurer investigates any claim made by an insured to determine the validity of the claim prior to making payment on that claim. Each insurer conducts no business other than the issuing and administering of insurance contracts.

No insured has any obligation to pay any insurer additional premiums if that insured's actual losses during any period of coverage exceed the premiums paid by that insured. Premiums paid by any insured may be used to satisfy claims of the other insureds. No insured that terminates its insurance coverage is required to make additional premium or capital payments to that insurer to cover losses in excess of its premiums paid. There is a real possibility that an insurer will sustain a loss in excess of the premiums it has received from its insureds. Finally, Company is not related to any other of the Number I insurers participating in the reinsurance pool, nor is Company related to any of the Number K independent insureds who are directly insured by any of the Number I other insurers participating in the reinsurance pool.

As a result of Company's participation in the reinsurance pool, the written premiums of Company will, generally, have the following characteristics on each line of coverage it insures: (a) Company will assume (in total) risks from more than 12 independent

[2] Coinsurance Agreements A and B state that these agreements including attachments or amendments signed and dated in writing by a duly authorized insurance manager, agent, or officer of the parties constitutes the entire contract between the parties.

policyholders with respect to insured businesses of these policyholders, and (b) no single insured will account for more than 15 percent of the total risks assumed by Company. Also, it is represented that there are no guarantees of Company's obligations by Individual A or any other related person. In addition, Company states that it is well capitalized in the amount of $x. Company does not make any loans to its affiliated insureds.

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. LeGierse, 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 as 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 percent of the risk, but does if other insureds constitute more than 50 percent of the risk.

Rev. Rul. 2002-90, 2002-2 C.B. 985, holds than an arrangement between a licensed insurance subsidiary of parent, and each of the 12 of parent's operating subsidiaries where, *inter alia*, no one subsidiary accounts for less than 5 percent nor more than 15 percent 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 percent 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. 2009-29, 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 example, both direct insurance and reinsurance business may qualify a taxpayer as an insurance company under § 816(a) or 831(c), as applicable.[3]

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 though 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

[3] On the other hand, § 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.

§ 816(a), the court concluded that Alinco was in the business of "reinsuring risks" underwritten by insurance companies.

Section 162(a) of the Internal Revenue 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 any 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.

The present situation involves Company directly writing a small number of policies to related insureds. More importantly, however, under Coinsurance Agreement A, Company contributes a substantial amount of its direct consideration (received from its insureds) and associated risks to the pool, and under Coinsurance Agreement B, receives a quota share of the consideration and associated risks from the pool roughly equal in dollar terms to Number J percent of the amount Company ceded to the pool on each line of coverage. The result is that there are a significant number of unrelated covered entities such that none is paying for a significant portion of its own risk. Accordingly, given that insurance risks are covered, the arrangement achieves adequate risk shifting and risk distribution such that the contracts issued by Company to its insureds 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 matter described above), we conclude that the arrangement between the insureds and Company constitutes insurance for federal income tax purposes, such that consideration paid by the insureds 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 Regulations. 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 reinsurance pool is an entity for federal income tax purposes. 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,

SHERYL B. FLUM
Chief, Branch 4
Office of the Associate Chief Counsel
(Financial Institutions & Products)