Internal Revenue Service
Appeals Office

Release Number: **201609008**
Release Date: 2/26/2016
Date: December 03, 2015
UIL Code: 501.15-00

ORG
ADDRESS

Certified Mail

Department of the Treasury

Employer Identification Number:

Person to Contact:

Employee ID Number:
Tel:
Fax:

Tax Period(s) Ended:
December 31, 20XX
December 31, 20XX
December 31, 20XX

UIL: 0501.15-00

Dear :

This is a final determination that you do not qualify for exemption from Federal income tax under Internal Revenue Code (the "Code") section 501(a) as an organization described in Code section 501(c)(15) for the tax periods listed above.

The final adverse determination of your exempt status was made for the following reason(s):

Taxpayer is not an insurance company exempt from tax pursuant to Code § 501(c)(15) as of 20XX, 20XX and 20XX.

You are required to file Federal income tax returns on Forms 1120 for the tax periods stated in the heading of this letter and for all tax years thereafter. File your return with the appropriate Internal Revenue Service Center per the instructions of the return. For further instructions, forms, and information please visit www.irs.gov.

Please show your employer identification number on all returns you file and in all correspondence with Internal Revenue Service.

We will make this letter and the proposed adverse determination letter available for public inspection under Code section 6110 after deleting certain identifying information. We have provided to you, in a separate mailing, Notice 437, *Notice of Intention to Disclose*. Please review the Notice 437 and the documents attached that show our proposed deletions. If you disagree with our proposed deletions, follow the instructions in Notice 437.

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.

Sincerely Yours,

Appeals Team Manager

Enclosure: Publication 556

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE

TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

Date: January 15,2013

Taxpayer Identification Number:

ORG
ADDRESS

Form:
990-EZ/990
Tax Period(s) Ended:
12/31/20XX;12/31/20XX; 12/31/20XX
Person to Contact/ID Number:

Contact Numbers:
Telephone:
Fax:

Dear :

During our examination of the returns indicated above, we determined that your organization was not described in Internal Revenue Code section 501(c) for the tax periods listed above and therefore, it does not qualify for exemption from federal income tax. This letter is not a determination of your exempt status under section 501 for any periods other than the tax periods listed above.

The attached Report of Examination, Form 886-A, summarizes the facts, the applicable law, and the Service's position regarding the examination of the tax periods listed above. You have not agreed with our determination, or signed a Form 6018-A, Consent to Proposed Action, accepting our determination of non-exempt status for the periods stated above. You have not agreed to file the required income tax returns. You may appeal your case. The enclosed Publication 3498, The Examination Process, and Publication 892, Exempt Organizations Appeal Procedures for Unagreed Issues, explain how to appeal an Internal Revenue Service (IRS) decision. Publication 3498 also includes information on your rights as a taxpayer and the IRS collection process.

If you request a conference with Appeals, you must submit a written protest within 30 days of the date of this letter. An Appeals officer will review your case. The Appeals Office is independent of the Director, EO Examinations. Most disputes considered by Appeals are resolved informally and promptly.

You may also request that we refer this matter to IRS Headquarters for technical advice as explained in Publication 892. If you do not agree with the conclusions of the technical advice memorandum, no further administrative appeal is available to you within the IRS on the issue that was the subject of the technical advice.

If we do not hear from you within 30 days of the date of this letter, we will issue a Statutory Notice of Deficiency based on the adjustments shown in the enclosed report of examination.

You have the right to contact the office of the Taxpayer Advocate. Taxpayer Advocate assistance is not a substitute for established IRS procedures, such as the formal appeals process. The Taxpayer Advocate cannot reverse a legally correct tax determination, or extend the time fixed by law that you have to file a petition in a United States court. The Taxpayer Advocate can see that a tax matter that may not have been resolved through normal channels gets prompt and proper handling. You may call toll-free 1-877-777-4778 and ask for Taxpayer Advocate Assistance. If you prefer, you may contact your local Taxpayer Advocate at:

Taxpayer Advocate Service

In the future, if you believe your organization qualifies for tax-exempt status, and would like to establish its status, you may request a determination from the IRS by filing Form 1024, Application for Recognition of Exemption under Section 501(a), and paying the required user fee.

If you have any questions, please call the contact person at the telephone number shown in the heading of this letter. If you write, please provide a telephone number and the most convenient time to call if we need to contact you.

Thank you for your cooperation.

Sincerely,

Director, EO Examinations

Enclosures:
Publication 892
Publication 3498
Form 6018-A
Report of Examination
Envelope

Form 886-A (Rev. January 1994)	EXPLANATIONS OF ITEMS		Schedule number or exhibit
Name of taxpayer ORG		Tax Identification Number	Year/Period ended 12/31/20XX 12/31/20XX 12/31/20XX

ISSUES:

1. Whether the contracts executed by ORG constitute contracts of insurance?
2. Whether the arrangement entered into by ORG involves the requisite element of risk distribution?
3. Whether more than half of the business of ORG during each of the taxable years under consideration is the issuing of insurance or annuity contracts or the reinsuring of risks underwritten by insurance companies?
4. If ORG is not an insurance company, does it qualify for treatment as a tax-exempt entity under section 501(c)(15) of the Internal Revenue Code?
5. Is the IRC 953(d) election valid if the taxpayer is not an insurance company, and the election was never approved by the Service?

FACTS:

ORG (hereinafter "Taxpayer") was formed and incorporated in Country, Territory on December 3, 20XX, under the provisions of Section 9 of the Companies Act, 2000. The taxpayer was formed to provide certain property and casualty insurance type services. The taxpayer is formed as a foreign captive insurance company. The taxpayer is authorized to issue 0 common shares with a $0 par value, and actually issued 0 shares in consideration of $0 capital contribution from its sole shareholder.

The taxpayer is wholly owned by CO-1, a State Limited Liability Company. CO-1 is not engaged in any business activity and does not file Federal income tax returns. CO-1, is co-equally owned and controlled by Owner and Co-Owner. Both individuals are United States citizen and residents of the State of State.

The TEGE examine agent obtained a copy of ORG's Form 1024 application administrative file from the Exempt Organizations Records Unit in City on February 18, 20XX. The administrative file included a copy of the Form 1024 application; Articles of Incorporation; the IRC 953(d) election statement; a copy of the insurance licenses for 20XX and 20XX; regulatory filings and responses of Insurance Regulators; insurance underwriting diagrams; organizational owner chart; supplemental information for the Form 1024; financial forecasts for years 20XX through 20XX; forms of credit reinsurance agreements entered into by the company; and a copy of the 20XX insurance policies issued by the company.

Other documents were received from CPA, CPA, in response to Information Document Requests issued by the examining agent during the audit process.

According to the Articles of Incorporation, the taxpayer is to be governed by a board of directors composed of one to seven directors. The board is actually composed of two directors, Owner and Co-Owner. Owner also serves as Chief Executive Officer (CEO), President, Treasurer, and Assistant Secretary of ORG Co-Owner serves as Vice President, Secretary, and Assistant Treasurer of the company.

Owner and Co-Owner are also equally co-owners of CO-2, located in City, State. The company is engaged in commercial machinery repair & maintenance service. Owner and Co-Owner also own CO-3 and CO-4. The exact nature of the business conducted by these entities is unknown. These business interests are collectively referred to as "Affiliated Business Interests." According ORG's Business Plan,

> The Affiliated Business Interests desired to insure certain of their property and casualty exposures, and are unwilling, or in some cases, unable to do so through the conventional insurance marketplace. The Affiliated Business Interests looked at alternative methods of arranging such insurance coverage and have found that providing such coverage through a captive insurance company offers the best method for satisfying its needs. ORG will be operated primarily to accomplish this objective.

The taxpayer was created as a controlled foreign corporation. The taxpayer is not a member of a controlled group of corporations. As a controlled foreign corporation, Owner, President, signed an IRC 953(d) election statement on February 23, 20XX. It appears that the election statement was filed with the IRS , State office on the same day.

On September 18, 20XX, the company filed Form 1024, Application for Recognition of Exemption Under Section 501(a), seeking exemption as a small insurance company under section 501(c)(15) of the Internal Revenue Code. The application was received by TEGE in City on September 21, 20XX. The application revealed that 20XX was the initial tax year of the company. As of the filing of the Form 1024 application, the taxpayer had filed Form 990 for the tax year ended December 31, 20XX, with the Ogden Service Center. Owner, President, signed the application on September 15, 20XX. A Form 2848, Power of Attorney, accompanied the application authorizing Attorney-1, Attorney, and Attorney-2, Attorney, to represent the company during the application process. The attorneys worked for a law firm in

The application revealed that the taxpayer employed CO-5, to serve as its resident insurance manager in Country, Territory. The taxpayer agreed to pay compensation of less than $0 annually.

The Form 1024 application was referred to Rulings and Agreements in Washington, D.C., on October 23, 20XX, for consideration and ruling. The application was assigned to a Tax Law Specialist on or around November 13, 20XX. No action was taken on the application until July 20XX. On July 26, 20XX, the Tax Law Specialist mailed a letter to the company's domestic address, at Address, Suite, City, State Zip code, to request additional information about the operations. The taxpayer's response to the letter was due by August 26, 20XX. Attorney-2, Attorney, submitted a letter dated August 19, 20XX, requesting an extension of time to respond until September 26, 20XX.

Instead of responding to the additional information request of the Tax Law Specialist, the company's President, Owner, submitted a letter on September 16, 20XX, to request that the Form 1024 application be withdrawn from further consideration and ruling.
On September 28, 20XX, the Tax Law Specialist closed the application file and issued a letter informing the company that their request to withdraw the application was accepted and no further action would be taken on the application.

Thus, the taxpayer did not receive a favorable or final adverse ruling letter from TEGE, Rulings and Agreements. In addition to not completing the exemption application process, there is no evidence that its IRC 953(d) election statement was approved by the Internal Revenue Service. On February 22, 20XX, the TE/GE examining agent requested the effective date of the IRC 953(d) election from the IRS , State office. On February 28, 20XX, the IRS , State office informed the examining agent that the Service did not have record that the IRC 953(d) election was approved.

The taxpayer filed a Form 990-EZ return for its initial tax year that consisted of the period December 3, 20XX, through December 31, 20XX. The company also filed Form 990 returns for the 20XX and 20XX calendar years.

The taxpayer operated primarily to provide property and casualty "insurance" coverage to CO-2., CO-3; and CO-4 ("hereinafter called "Affiliated Businesses"), which are owned and controlled by Owner and Co-Owner, officers and beneficial owners of ORG The Financial Services Commission, Country, issued a Class 'B: General Insurance License to the taxpayer, effective December 3, 20XX.

In 20XX, the taxpayer wrote thirteen direct-written "insurance" contracts to CO-2 titled: (1) Special Risk – Loss of Services Insurance Policy; (2) Special Risk – Product Recall Insurance Policy; (3) Special Product – Weather Related Business Interruption Insurance Policy; (4) Special Risk – Regulatory Changes Insurance Policy; (5) Special Risk – Tax Liability Insurance Policy; (6) Special Risk – Punitive Wrap Liability Insurance Policy; (7) Excess Pollution Insurance Policy; (8) Special Risk – Loss of Major Customer Insurance Policy; (9) Excess Intellectual Property Package Policy; (10) Special Risk – Expense Reimbursement Insurance Policy; (11) Excess Employment Practices Liability Insurance Policy; (12) Excess Directors & Officers Liability Insurance Policy; and (13) Excess Cyber Risk. Each of the above-named policies is described in detail below.

Special Risk – Loss of Services Insurance Policy provides for the indemnification of the Affiliated Businesses for an involuntary loss of services of a key employee, Owner, for sickness, disability, death, loss of license, termination of employment; resignation; retirement; or any other occurrence that deprives the Affiliated Businesses from the receipt in a material and substantial way of his services.

Special Risk – Product Recall Insurance Policy provides for the indemnification of the Affiliated Businesses for expenses involved in the recall of "all products manufactured and/or sold by the Affiliated Businesses during 20XX.

Special Risk – Weather Related Business Interruption Insurance Policy provides for the indemnification of the Affiliated Businesses for any business interruption loss of up to 12 months suffered as a result of any Weather Event such as significant flooding, catastrophic snow, hail, freezing, rain, tornados, and tsunamis, that has an adverse impact on the normal on-going business operations.

Special Risk – Regulatory Changes Insurance Policy covers actual compliance expenses and business interruptions suffered as a result of any regulatory change having an adverse impact on the normal on-going business operations of the Affiliated Businesses. The policy does not cover adverse regulatory changes resulting from substantial noncompliance with regulations or guidelines or those changes initiated in direct response to negligent acts, omissions, or errors by the Affiliated Businesses.

Special Risk – Tax Liability Insurance Policy provides the Affiliated Businesses with indemnification up to 0% of the amount of additional tax liability each may incur on its 20XX federal income tax return. No coverage is provided for additions to tax, civil penalties, or criminal penalties for delinquent returns or criminal or fraudulent acts.

Special Risk – Punitive Wrap Liability Insurance Policy provides that ORG will pay claims filed by the Affiliated Businesses, resulting from the failure of an insurer to cover punitive or exemplary damages, judgments, or awards, related to the other 0 policies, solely due to the enforcement of any law or judicial ruling that precludes the insuring of such damages and that but for such law or judicial ruling would otherwise be covered.

Excess Pollution Liability Insurance Policy provides for the indemnification of the Affiliated Businesses against clean up cost and diminution of property value due to any pre-existing and new on-site pollution and environmental contamination.

Special Risk – Loss of Major Customer Insurance Policy provides for the indemnification of the Affiliated Businesses for any business interruption loss of up to 12 months suffered as a result of losing the services of any Major Customer. A major customer is defined as "any customer who represents 0% of more of annual sales for the six months preceding the loss.

Excess Intellectual Property Package Policy provides indemnification subject to certain limitations to the Affiliated Businesses for all damages legally obligated to pay for litigation expenses, mitigation expenses, investigation expenses, costs to replace, restore, or re-create intellectual property, additional damages and rewards resulting from wrongful acts committed during the policy period. Wrongful acts include infringement of copyright, plagiarism, invasion or interference of right of privacy or publicity; libel; slander; piracy or unfair competition; breach of contract; patent infringement; and malicious prosecution with regard to intellectual property.

Special Risk – Expense Reimbursement Insurance Policy covers public relations expenses to mitigate adverse publicity to the Affiliated Businesses under certain circumstances, including: actual or imminent incidents where the insureds potential liability amount is in excess of $0; product recalls; layoffs and labor disputes; government or regulatory litigation; bankruptcy or other major financial crisis; loss of intellectual property rights; unsolicited takeover bids; terrorism; or any other adverse incident expected to reduce the insureds annual gross revenue by at least 0%. The policy also covers all expenses for the Affiliated Businesses defenses to actual or alleged civil liability.

Excess Employment Practices Liability Insurance Policy provides for the indemnification of the Affiliated Businesses against all costs and expenses incurred as a result of claims filed by employees for wrongful termination, dismissal, discharge, sexual harassment, unlawful employment discrimination and employment related invasion of privacy and defamation.

Excess Directors & Officer Liability Insurance Policy provides indemnification subject to certain limitations to the Affiliated Businesses for their indemnification of its officers and directors for wrongful acts, including any error, misstatement, misleading statement, act, omission, neglect, or breach of duty committed, attempted, or allegedly committed or attempted by an officer or director of the Affiliated Businesses. The policy also covers similar acts in relation to mergers and acquisitions. Moreover, the policy includes liability for pollution. The policy also provides direct and executive liability coverage for similar acts to the Affiliated Businesses officers and directors.

Excess Cyber Risk Insurance Policy provides indemnification to the Affiliated Businesses against claims resulting from content liability and interruption of business due to cyber crimes such as corruption of computer systems dues to viruses and other malicious codes.

With respect of each of the 13 above referenced property and casualty contracts, the taxpayer and CO-6. ("CO-6") entered into an agreement titled, "Joint Underwriting Stop Loss Endorsement." The taxpayer and CO-6 are separate independent companies and are not owned and controlled by related parties. Nor is CO-6 related to shareholders, directors, or officers of the taxpayer. Under the terms of the agreement, the taxpayer is responsible for payment of claims up to certain specified thresholds. If the specified thresholds are met, then CO-6 becomes liable for payment of claims up to certain specified limits. If the specified limits for CO-6's payment of claims are exceeded, then the taxpayer again becomes liable. It also appears that for each of the 13 direct-written contracts, the taxpayer received 0% of the total premiums, and CO-6 received 0% of the total premiums. Page 5, paragraph 4 of the agreement reads as follows:

> The premium rate for this Joint Underwriting Stop Loss Endorsement is 0% of the combined gross direct written premiums for the specified policies due directly from the Insured(s). This endorsement premium of $0 out of the total premiums of $0 is payable directly from the Insured(s) to the Stop Loss Insurer.

Therefore, under the terms of the Joint Underwriting Stop Loss Endorsement agreement, the Affiliated Businesses were required to pay of total premiums of $0 for the thirteen direct written policies and for the stop loss endorsement. Of the total premium, the Affiliated Businesses paid $0 directly to the taxpayer (0%) as Lead Insurer. In addition, the Affiliated Businesses paid $0 as a reinsurance premium directly to CO-6., as the Stop Loss Insurer.

Based on the review of the contracts, the premiums paid by the Named Insureds under the terms of the 20XX contracts was as follows:

Contracts	Total Premium	Portion of Premium To Taxpayer (0%)
1. Special Risk-Loss of Services	$ 0	$ 0
2. Special Risk-Product Recall	0	0
3. Special Risk-Weather Related Bus. Interruption	0	0
4. Regulatory Changes	0	0
5. Special Risk Tax Liability	0	0
6. Special Risk Punitive Wrap Liability	0	0
7. Excess Pollution Liability	0	0
8. Special Risk-Loss of Major Customer	0	0
9. Excess Intellectual Property	0	0
10. Special Risk-Expense Reimbursement	0	0
11. Excess Employment Practices Liability	0	0
12. Excess Directors & Officers Liability	0	0
13. Excess Cyber Risk	0	0
Totals	$ 0	$ 0

The taxpayer also entered into two types of reinsurance arrangements. The first arrangement is referred to as a "reinsurance risk pooling program." Under this arrangement, the taxpayer participated in a "reinsurance risk pool" with several other unrelated insurance companies ("pool participants"). The risk pool was operated by CO-6. Each pool participant had one or more affiliated operating entities for which it underwrote insurance coverage, generally casualty type coverage such as credit life and credit disability. CO-6 insured a portion of the direct insurance underwritten by the pool participants using a so-called "stop loss" endorsement. CO-6 participated in over 0 insurance policies with more than 0 insureds. CO-6 blended together its direct written insurance, and then reinsured the entire book on a quota share basis with each of the pool participants.

According to the terms of the 20XX Quota Share Reinsurance Policy executed with CO-6., the taxpayer was one of 0 companies listed as reinsurer. As Reinsurer #0, the taxpayer was to retained 0% of its Quota Share Retained Premiums from CO-6. in exchange for the assumption of 0% of the risk pool comprised of the stop loss coverages issued during the policy period by CO-6 Insurance Company to all stop loss endorsement policyholders. CO-6. paid total reinsurance premiums of $0 to 0 Reinsurers. Of this total premium, the taxpayer received a quota share reinsurance premium equal to 0% or $0, of which $0 is the portion of the premium retained by taxpayer (as a quota share retained premium) until the final accounting and settlement of the Risk Pool was completed. The final accounting and settlement generally occurs 180 days following the expiration date shown in the Policy Declaration. The quota share retained premium was calculated at 0% of the quota share reinsurance policy premium of $0. The risk pool insured by CO-6 and reinsured by the 0 pool participants included the thirteen direct written policies written and sold by the taxpayer to the Affiliated Business Interests. According to the general ledger, the taxpayer reported receiving a reinsurance premium of $0 from CO-6 in 20XX.

Under the terms of the second reinsurance arrangement, which is referred to as the Credit Coinsurance Reinsurance Program, the taxpayer assumed reinsurance contracts from CO-6. The taxpayer reinsured a 0% quota share of the risks from vehicle service contracts reinsured by CO-6. The vehicle service contracts were initially written by CO-7 Company in 20XX, assumed by CO-8, then by CO-9 from CO-8; and finally assumed by CO-6. from CO-9 The taxpayer received a pro rata share (0%) of the earned premiums received by CO-6. The taxpayer was paid a reinsurance premium of $0 from CO-6. in 20XX.

For the tax year ended December 31, 20XX, the taxpayer reported gross receipts and total revenue of $0. Total revenue was derived primarily from premiums received from the direct written, reinsurance risk pooling program, and the credit coinsurance reinsurance program. The taxpayer received gross receipts as follows:

	20XX	
Program Revenue Service		
Direct Written Premiums	$ 0	0%
Quota Share Reinsurance Premiums	0	0
Credit Coinsurance Reinsurance Premiums	0	0
Investment Income	0	0
Gain of sale of assets	-0-	-0-
Other income	-0-	-0-
Total Revenue	$ 0	0%

The checking account (#) bank statement for December 31, 20XX, with Bank, reflected three deposits totaling $0. The statement reflected a deposit of $0 on December 29, 20XX, which represented the payment of insurance premiums received from the Affiliated Businesses from the thirteen direct written insurance policies. Another deposit of $0 was made on December 10, 20XX, which represented the initial contribution of capital made by CO-1, the sole shareholder of the taxpayer. The only other deposit made during 20XX was interest income credited to the account on December 31, 20XX, in the amount of $0.

As of December 31, 20XX, the taxpayer's assets totaled $0, which consisted primarily of cash in its checking account of $436,056 and reinsurance premiums receivable of $0.

20XX and 20XX Tax Years

During the tax periods ending December 31, 20XX, and December 31, 20XX, the taxpayer wrote 11 contracts insuring risks of the Affiliated Businesses, which are owned and controlled by Owner and Co-Owner, officers and beneficial owners of ORG The taxpayer insured risks for the same 11 contracts in 20XX and 20XX. The contracts in effect for both years are as follows:

Excess Directors & Officers Liability provides indemnification subject to certain limitations to the Affiliated Businesses for their indemnification of its officers and directors for wrongful acts, including any error, misstatement, misleading statement allegedly committed or attempted by an officer or director of the Affiliated Businesses. The policy also covers similar acts in relation to mergers and acquisitions. Moreover, the policy, act, omission, neglect, or breach of duty committed, attempted, or includes liability for pollution. The policy also provides direct and executive liability coverage for similar acts to the Affiliated Businesses officers and directors.

Special Risk – Loss of Major Customer provides for the indemnification of the Affiliated Businesses for any business interruption loss of up to 12 months suffered as a result of losing the services of any Major Customer. A major customer is defined as "any customer who represents 0% of more of annual sales for the six months preceding the loss.

Special Risk – Expense Reimbursement covers public relations expenses to mitigate adverse publicity to the Affiliated Businesses under certain circumstances, including: actual or imminent incidents where the insureds potential liability amount is in excess of $0; product recalls; layoffs and labor disputes; government or regulatory litigation; bankruptcy or other major financial crisis; loss of intellectual property rights; unsolicited takeover bids; terrorism; or any other adverse incident expected to reduce the insureds annual gross revenue by at least 0%. The policy also covers all expenses for the Affiliated Businesses defenses to actual or alleged civil liability.

Expense Reimbursement – Legal Expense covers defense expenses where the company has no underlying insurer, or the company has exhausted all defense expenses covered under their primary insurance policy; lost of work time resulting from responding to discovery requests and travel expenses to meetings, dispositions, and trials; costs of hiring independent counsel in addition to that provided by the primary liability insurer in order to ensure that the interests of the company are met and to provide additional assistance in the litigation; and expert witness fees and travel expenses.

Special Risk – Loss of Services provides for the indemnification of the Affiliated Businesses for an involuntary loss of services of a key employee, Owner, for sickness, disability, death, loss of license, termination of employment; resignation; retirement; or any other occurrence that deprives the Affiliated Businesses from the receipt in a material and substantial way of his services.

Excess Pollution Liability provides for the indemnification of the Affiliated Businesses against clean up cost and diminution of property value due to any pre-existing and new on-site pollution and environmental contamination.

Special Risk – Tax Liability provides the Affiliated Businesses with indemnification up to % of the amount of additional tax liability each may incur on its 20XX federal income tax return. No coverage is provided for additions to tax, civil penalties, or criminal penalties for delinquent returns or criminal or fraudulent acts.

Excess Intellectual Property Package provides indemnification subject to certain limitations to the Affiliated Businesses for all damages legally obligated to pay for litigation expenses, mitigation expenses, investigation expenses, costs to replace, restore, or re-create intellectual property, additional damages and rewards resulting from wrongful acts committed during the policy period. Wrongful acts include infringement of copyright, plagiarism, invasion or interference of right of privacy or publicity; libel; slander; piracy or unfair competition; breach of contract; patent infringement; and malicious prosecution with regard to intellectual property.

Special Risk – Regulatory Change covers actual compliance expenses and business interruptions suffered as a result of any regulatory change having an adverse impact on the normal on-going business operations of the Affiliated Businesses. The policy does not cover adverse regulatory changes resulting from substantial noncompliance with regulations or guidelines or those changes initiated in direct response to negligent acts, omissions, or errors by the Affiliated Businesses.

Special Risk – Punitive Wrap provides that ORG will pay claims filed by the Affiliated Businesses, resulting from the failure of an insurer to cover punitive or exemplary damages, judgments, or awards, related to the other 0 policies, solely due to the enforcement of any law or judicial ruling that precludes the insuring of such damages and that but for such law or judicial ruling would otherwise be covered.

Special Risk – Product Recall provides for the indemnification of the Affiliated Businesses for expenses involved in the recall of "all products manufactured and/or sold by the Affiliated Businesses during 20XX and 20XX.

With respect of each of the 11 above referenced property and casualty contracts, the taxpayer and CO-6. ("CO-6") entered into an agreement titled, "Joint Underwriting Stop Loss Endorsement" in 20XX and 20XX. The taxpayer and CO-6 are separate independent companies and are not owned and controlled by related parties. Nor is CO-6 related to shareholders, directors, or officers of the taxpayer. Under the terms of the agreement, the taxpayer is responsible for payment of claims up to certain specified thresholds. If the specified thresholds are met, then CO-6 becomes liable for payment of claims up to certain specified limits. If the specified limits for CO-6's payment of claims are exceeded, then the taxpayer again becomes liable. In 20XX, the taxpayer assumed 0% of the risk and received 0% of the direct written premiums. CO-6 received 0% of the total premiums. In 20XX, the taxpayer assumed 0% of the risk and received 0% of the direct written premiums. CO-6 received 0% of the direct written premiums in 20XX. The 20XX and 20XX Joint Underwriting Agreements include the following terms:

> The premium rate for this Joint Underwriting Stop Loss Endorsement is 0% (0% for 20XX) of the combined gross direct written premiums for the specified policies due directly from the Insured(s). For 20XX and 20XX, endorsement premiums of $0 and $0 out of the total premiums of $0 and $0, respectively, is payable directly from the Insured(s) to the Stop Loss Insurer.

Therefore, under the terms of the Joint Underwriting Stop Loss Endorsement agreement, the Affiliated Businesses were required to pay of total premiums of $0 for the eleven direct written policies written in 20XX, and total premiums of $0 for the same eleven policies renewed for 20XX. Of the total premiums, the Affiliated Businesses paid $0 in 20XX and $0 in 20XX, directly to the taxpayer (0%) as Lead Insurer. The Affiliated Businesses also paid $0 and $0, in 20XX and 20XX, as reinsurance premiums directly to CO-6., as the Stop Loss Insurer.

Based on the review of the contracts, the premiums paid by the Named Insureds under the terms of the 20XX contracts was as follows:

Contracts	Total Premium	Portion of Premium To Taxpayer (%)
1. Excess Directors & Officers Liability	$ 0	$ 0
2. Special Risk-Loss of Major Customer	0	0
3. Special Risk-Expense Reimbursement	0	0

4. Expense Reimbursement-Legal Expenses	0	0
5. Special Risk-Loss of Services	0	0
6. Excess Pollution Liability	0	0
7. Special Risk-Tax Liability	0	0
8. Excess Intellectual Property	0	0
9. Special Risk-Regulatory Changes	0	0
10. Special Risk-Punitive Wrap	0	0
11. Special Risk-Product Recall	0	0
Totals	$ 0	0

Based on the review of the contracts, the premiums paid by the Named Insureds under the terms of the 20XX contracts was as follows:

Contracts	Total Premium	Portion of Premium To Taxpayer ([redacted] %)
1. Excess Directors & Officers Liability	$	$
2. Special Risk-Loss of Major Customer	0	0
3. Special Risk-Expense Reimbursement	0	0
4. Expense Reimbursement-Legal Expenses	0	0
5. Special Risk-Loss of Services	0	0
6. Excess Pollution Liability	0	0
7. Special Risk-Tax Liability	0	0
8. Excess Intellectual Property	0	0
9. Special Risk-Regulatory Changes	0	0
10. Special Risk-Punitive Wrap	0	0
11. Special Risk-Product Recall	0	0
Totals	$ 0	$ 0

The taxpayer also entered into two types of reinsurance arrangements in 20XX and 20XX. The first arrangement is referred to as a "reinsurance risk pooling program (also called CO-10)." Under this arrangement, the taxpayer participated in a "reinsurance risk pool" with several other unrelated insurance companies ("pool participants"). The risk pool was operated by CO-6. Each pool participant had one or more affiliated operating entities for which it underwrites insurance coverage, generally casualty type coverage such as credit life and credit disability. CO-6 insured a portion of the direct insurance underwritten by the pool participants using a so-called "stop loss" endorsement. CO-6 participated in over 0 insurance policies with more than 0 insureds. CO-6 blended together its direct written insurance, and then reinsures the entire book on a quota share basis with each of the pool participants. In 20XX, the taxpayer was one of 63 reinsurers participating in the risk pool. The taxpayer, as Reinsurer #0, retained 0% of a Quota Share Premium from CO-6. in exchange for the assumption of 0% of the risk pool comprised of the stop loss coverages issued during the policy period by CO-6

Insurance Company to all stop loss endorsement policyholders. CO-6. paid total reinsurance premiums of $0 to 0 Reinsurers. Of this total premium, the taxpayer received a quota share reinsurance premium equal to 0% or $0 of which $0 is the portion of the premium retained by taxpayer (as a quota share retained premium) until the final accounting and settlement of the Risk Pool was completed. The quota share retained premium was calculated at 0% of the quota share reinsurance policy premium of $0. The risk pool insured by CO-6 and reinsured by the 0 pool participants included the eleven direct written policies written and sold by the taxpayer to the Affiliated Business Interests. According to the general ledger, the taxpayer reported receiving a reinsurance premium of $0 from CO-6 in 20XX.

In 20XX, the risk pool consisted of 0 reinsurers. As Reinsurer #0, the taxpayer retained 0% of a Quota Share Premium, from CO-6., in exchange for the assumption of 0% of the risk pool comprised of the stop loss coverages issued during the policy period by CO-6 Insurance Company to all stop loss endorsement policyholders. CO-6. paid total reinsurance premiums of $0 to 0 Reinsurers. Of this total premium, the taxpayer received a quota share reinsurance premium equal to 0% or $0 of which $0 is the portion of the premium retained by taxpayer (as a quota share retained premium) until the final accounting and settlement of the Risk Pool was completed. The quota share retained premium was calculated at 0% of the quota share reinsurance policy premium of $0. The risk pool insured by CO-6 and reinsured by the 0 pool participants included the eleven direct written policies written and sold by the taxpayer to the Affiliated Business Interests. According to the general ledger, the taxpayer received reinsurance premiums of $0 from CO-6 in 20XX.

The second reinsurance arrangement is called "Credit Coinsurance Reinsurance Program." Under the terms of the 20XX and 20XX contracts, the taxpayer assumed reinsurance contracts from CO-6. The taxpayer reinsured a 0% and 0% quota share of the risks, respectively, from vehicle service contracts reinsured by CO-6 . The vehicle service contracts were initially written by in 20XX, assumed by CO-8, then by CO-9 from ; and finally assumeu uy CO-6. from CO-9 The taxpayer received a pro rata share (0%) of the earned premiums received by CO-6. The taxpayer received a reinsurance premium of $0 in 20XX, and $0 in 20XX, from CO-6.

For the tax years ended December 31, 20XX, the taxpayer reported gross receipts and total revenue of $0. Total revenue was derived primarily from premiums received from the direct written, reinsurance risk pooling program, and the credit coinsurance reinsurance program. The taxpayer received total revenue as follows:

		20XX	
Program Revenue-Service			
Direct Written Premiums	$	0	0%
Quota Share Reinsurance Premiums		0	0
Credit Coinsurance Reinsurance Premiums		0	0

Form 886-A (Rev. January 1994)	EXPLANATIONS OF ITEMS		Schedule number or exhibit
Name of taxpayer ORG		Tax Identification Number	Year/Period ended 12/31/20XX 12/31/20XX 12/31/20XX

Investment Income	0	0
Gain of sale of assets	-0-	-0-
Other income: Premium Finance Charge	0	0
Total Revenue	$ 0	0%

Of the total premiums received by the taxpayer in 20XX, % of the premiums were generated from the eleven direct written policies with the Affiliated Business Interests, CO-2., CO-3, and CO-4, 0% of the premiums are from the Reinsurance Risk Pooling Program; and 0% of the premiums from the Credit Coinsurance Reinsurance Program.

As of December 31, 20XX, the taxpayer's assets totaled $0, which consisted primarily of cash in its checking account of $0 and investment in publicly traded securities of $0.

For the tax years ended December 31, 20XX, the taxpayer reported gross receipts of $0, and total revenue of $0. Total revenue was derived primarily from premiums received from the direct written, reinsurance risk pooling program, and the credit coinsurance reinsurance program. The taxpayer received total revenue as follows:

	20XX	
Program Revenue Service		
Direct Written Premiums	$	%
Quota Share Reinsurance Premiums		
Credit Coinsurance Reinsurance Premiums		
Investment Income		
Gain of sale of assets		
Other income: Premium Finance Charge		
Total Revenue	$	100.00%

Of the total premiums received by the taxpayer in 20XX, 0% of the premiums were generated from the eleven direct written policies with the Affiliated Business Interests, CO-2., CO-3, and CO-4 % of the premiums are from the Reinsurance Risk Pooling Program; and % of the premiums from the Credit Coinsurance Reinsurance Program.[1]

As of December 31, 20XX, the taxpayer's assets totaled $0, which consisted primarily of cash in its checking and investment accounts of $0 and investment in publicly traded securities of $0.

[1] Actuarial studies were completed by CO-11; CO-12; CO-13; and CO-14, for pricing of coverages provided by ORG.

Form 886-A (Rev. January 1994)	EXPLANATIONS OF ITEMS	Schedule number or exhibit
Name of taxpayer ORG	Tax Identification Number	Year/Period ended 12/31/20XX 12/31/20XX 12/31/20XX

With respect to the direct contracts insured in 20XX, 20XX and 20XX, the taxpayer did not sale, write or issue separate policies to CO-2., CO-3, and CO-4, Each contract listed all three parties as the insured. The contracts also listed a single combined premium payment due to cover all three parties. The three named insured did not pay separate premiums to the taxpayer in 20XX, 20XX or 20XX. Nor did the parties have an agreement to show how the premium payments were to be allocated between them.

Based on the analysis of premiums received during the years under audit, two-thirds of the risks insured by the taxpayer was the risk from Affiliated Business Interests.

LAW:

Section 501(c)(15) of the Internal Revenue Code provides insurance companies [as defined in section 816(a)] other than life (including inter-insurers and reciprocal underwriters) can qualify for tax-exempt status if:

1. The gross receipts for the taxable year do not exceed $600,000, and more than 50% of such gross receipts consist of premiums, or

2. In the case of a mutual insurance company, the gross receipts of which for the taxable year do not exceed $150,000, and more than 35% of such gross receipts consist of premiums.

Section 831(c) defines the term "insurance company," for purposes of section 831, as having the same meaning as the terms is given under section 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 reinsuring the risks underwritten by insurance companies.

Pursuant to:

Helvering v. LeGierse, 312 U.S. 531 (1941), the United States Supreme Court in defining the term "insurance contract" held that in order for a contract to amount to an insurance contract, it must shift and distribute a risk of loss and that risk must be an "insurance" risk.

AMERCO, Inc. v. Commissioner, 979 F.2d 162, 164-65 (9th Cir. 1992), aff'g. 96 T.C. 18 (1991), "risk-shifting" means one party shifts his risk of loss to another, and "risk-distributing" means that the party assuming the risk distributes his potential liability, in part, among others. An arrangement without the elements of risk-shifting and risk-distributing lacks the fundamentals inherent in a true contract of insurance.

Allied Fidelity Corp. v. Commissioner, 572 F. 2d 1190, 1193 (7th Cir. 1978), the common definition for insurance is an agreement to protect the insured against a direct or indirect economic loss arising from a defined contingency whereby the insurer undertakes no present duty of ORG but stands ready to assume the financial burden of any covered loss.

Commissioner v. Treganowan, 183 F.2d 288, 290-91 (2d Cir. 1950), the risk must contemplate the fortuitous occurrence of a stated contingency.

Beech Aircraft Corp. v. United States, 797 F.2d 920, 922 (10th Cir. 1986), historically and commonly insurance involves risk –shifting and risk distributing. "Risk-shifting" means one party shifts his risk of loss to another, and "risk-distributing" means that the party assuming the risk distributes his potential liability, in part, among others. An arrangement without the elements of risk-shifting and risk-distributing lacks the fundamentals inherent in a true contract of insurance.

Ocean Drilling & Exploration Co. v. United States, 988 F.2d 1135, 1153 (Fed. Cir. 1993), for insurance purposes, "risk-shifting" means one party shifts his risk of loss to another, and "risk-distributing" means that the party assuming the risk distributes his potential liability, in part, among others.

Clougherty Packing Co. v. Commissioner, 811 F.2d 1297, 1300 (9th Cir. 1987), a true insurance agreement must remove the risk of loss from the insured party.

Humana, Inc. v. Commissioner, 881 F.2d 247, 257 (6th Cir. 1989), risk distribution involves shifting to a group of individuals the identified risk of the insured. The focus is broader and looks more to the insurer as to whether the risk insured against can be distributed over a larger group rather than the relationship between the insurer and any single insured.

Revenue Ruling 89-96, 1989-2 C.B. 114, an insurance agreement or contract must involve the requisite risk shifting necessary for insurance.

Revenue Ruling 2002-89, 2002-2 C.B. 984, it is not insurance where a parent company formed a subsidiary insurance company and 90% of the subsidiary's earned premium was paid by the parent company. The Rev. Rul. Further held that such arrangement between a parent and a subsidiary would constitute insurance if less than 50% of the premium earned by the subsidiary is from the parent company.

Revenue Ruling 60-275, 1960-2 C.B. 43, risk shifting not present where subscribers, all subject to the same flood risk, agreed to coverage under a reciprocal flood insurance exchange.

Revenue Ruling 2002-90, 2002 C.B. 985, a wholly owned subsidiary that insured 12 subsidiaries of its parent constitute insurance for federal income tax purposes.

Revenue Ruling 2005-40, 2005-40 I.R.B. 4, an arrangement that purported to be an insurance contract but lacked the requisite risk distribution was characterized as a deposit arrangement, a loan, a contribution to capital, an indemnity arrangement that was not an insurance contract.

Revenue Ruling 2007-47, 2007-30 I.R.B. 127, an arrangement that provides for the reimbursement of inevitable future costs does not involve the requisite insurance risk.

Foreign Corporation Tax Provisions

IRC SEC. 951. AMOUNTS INCLUDED IN GROSS INCOME OF UNITED STATES SHAREHOLDERS.

951(a) AMOUNTS INCLUDED. —

(1) IN GENERAL. —If a foreign corporation is a controlled foreign corporation for an uninterrupted period of 30 days or more during any taxable year, every person who is a United States shareholder (as defined in subsection (b)) of such corporation and who owns (within the meaning of section 958(a)) stock in such corporation on the last day, in such year, on which such corporation is a controlled foreign corporation shall include in his gross income, for his taxable year in which or with which such taxable year of the corporation ends —

(A) the sum of —

(i) his pro rata share (determined under paragraph (2)) of the corporation's subpart F income for such year,

(ii) his pro rata share (determined under section 955(a)(3) as in effect before the enactment of the Tax Reduction Act of 1975) of the corporation's previously excluded subpart F income withdrawn from investment in less developed countries for such year, and

(iii) his pro rata share (determined under section 955(a)(3)) of the corporation's previously excluded subpart F income withdrawn from foreign base company shipping operations for such year; and

IRC SEC. 953. INSURANCE INCOME.

953(a) INSURANCE INCOME. —

(1) IN GENERAL. —For purposes of section 952(a)(1), the term "insurance income" means any income which —

(A) is attributable to the issuing (or reinsuring) of an insurance or annuity contract, and

(B) would (subject to the modifications provided by subsection (b)) be taxed under subchapter L of this chapter if such income were the income of a domestic insurance company.

(2) EXCEPTION. —Such term shall not include any exempt insurance income (as defined in subsection (e)).

IRC SEC. 953. INSURANCE INCOME.

953(d) ELECTION BY FOREIGN INSURANCE COMPANY TO BE TREATED AS DOMESTIC CORPORATION.
(1) IN GENERAL. — If

(A) a foreign corporation is a controlled foreign corporation (as defined in section 957(a) by substituting "25 percent or more" for "more than 50 percent" and by using the definition of United States shareholder under 953(c)(1)(A)),

(B) such foreign corporation would qualify under part I or II of subchapter L for the taxable year if it were a domestic corporation,

(C) such foreign corporation meets such requirements as the Secretary shall prescribe to ensure that the taxes imposed by this chapter on such foreign corporation are paid, and

(D) such foreign corporation makes an election to have this paragraph apply and waives all benefits to such corporation granted by the United States under any treaty, for purposes of this title, such corporation shall be treated as a domestic corporation.

GOVERNMENT'S POSITION:

Form 1024 Application

The taxpayer filed a Form 1024 application on September 18, 20XX, seeking retroactive exemption under IRC 501(c)(15), back to December 3, 20XX, the date of incorporation. The application was ultimately withdrawn by Owner, President, on September 16, 20XX. The examining agent believes that the application was withdrawn by the taxpayer on the advice on its counsel, Attorney-3, Attorney-1, and Attorney-2, who are affiliated with The Law Firm, in

City, State. The examining agent believes that its counsel advised the taxpayer to withdraw the Form 1024 application because counsel anticipated EO Rulings and Agreements would deny IRC 501(c)(15) tax-exempt status to ORG based on the position taken by Rulings and Agreements on applications filed by other clients of The Law Firm.

The Law Firm represented many captive insurance companies that filed Form 1024 applications seeking tax-exempt status under IRC 501(c)(15). All of the applications included basically identical fact patterns, and organizational and operational structure. However, after EO Rulings and Agreements received an adverse opinion from the IRS, Office of Chief Counsel, Financial Institutions & Products Division, concluding that the applicants were not insurance companies within the meaning of Subchapter L of the Code, because the contracts executed by the companies lack adequate risk distribution, Rulings and Agreements began issuing adverse denial letters to these companies. The remaining companies suddenly withdrew their Form 1024 applications, probably anticipating that their applications would also be denied tax-exempt status by EO Rulings and Agreements.

The examining agent believes that the withdrawals of the remaining applications, including the application filed by the taxpayer, is more than mere coincidence. In addition, the examining agent believes the taxpayer withdrew its Form 1024 application upon advice from its counsel in order to avoid receiving an adverse denial letter from Rulings and Agreements.

Qualification as Insurance Company

Neither the Internal Revenue Code nor the Income Tax Regulations define the terms "insurance" or "insurance contract." The standard for evaluating whether an arrangement constitutes insurance for federal tax purposes has evolved over the years and is, at best, a nonexclusive facts and circumstances analysis. Sears, Roebuck and Co. v. Commissioner, 972 F.2d 858, 861-64 (7th Cir. 1992). The most frequently cited opinion on the definition of insurance is Helvering v. LeGierse, 312 U.S. 531 (1941), in which the Court describes "insurance" as an arrangement involving risk-shifting and risk-distributing of an actual "insurance risk" at the time the transaction was executed. Cases analyzing "captive insurance" arrangements have described the concept of "insurance" for federal income tax purposes as containing three elements: (1) involvement of an insurance risk; (2) shifting and distributing 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 test, however, is not a rigid three-prong test.

There is also no single definition of insurance for non-tax purposes. "[T]he subject has no useful, or fixed definition. There is neither a universally accepted definition or concept of 'insurance' nor a [sic] exclusive concept or definition that can be persuasively applied in insurance lawyering." 1 APPLEMAN ON INSURANCE 2d, § 1.3 (2005). While "it seems appropriate that any concept and meaning of insurance be sufficiently broad and flexible to meet the varying and innovative transactions which humankind perpetually produces," care must be used to describe insurance because "overbroad definitions are not useful and may cause many commercial relationships erroneously to constitute insurance." Id. Moreover, a state's determination of whether a product is insurance for state law purposes does not control whether the product is insurance for federal tax law. See AMERCO, 96 T.C. 18, 41 (1991). There is no need for parity between a state law definition and federal definition as the objective for state purposes is company solvency. Solvency is not a concern for determining whether an arrangement qualifies as insurance for federal income tax purposes.

Not all contracts that transfer risk are insurance policies even where the primary purpose of the contract is to transfer risk. For example, a contract that protects against the failure to achieve a desired investment return protects against investment risk, not insurance risk. LeGierse, 312 U.S. at 542 (the risk must not be merely an investment risk); Securities and Exchange Commission v. United Benefit Life Insurance Co., 387 U.S. 202, 211 (1967) (the transfer of an investment risk cannot by itself create insurance). See also, Rev. Rul. 89-96, 1989-2 C.B. 114 (risks transferred were in the nature of investment risk, not insurance risk); Rev. Rul. 68-27, 1968-1 C.B. 315 (although an element of risk existed, it was predominantly a normal business risk of an organization engaged in furnishing medical services on a fixed price basis rather than an insurance risk) and Rev. Rul. 2007-47, 2007-2 C.B. 127 (the arrangement lacked the requisite insurance risk to constitute insurance because the arrangement lacked fortuity and the risk at issue was akin to the timing and investment risks of Rev. Rul. 89-96).

The line between investment risk and insurance risk, however, is pliable.
[t]he finance and insurance industries have much in common. The different tools these industries provide their customers for managing financial insurable risks rely on the same two fundamental concepts: risk pooling and risk transfer. Further, the valuation techniques in both financial and insurance markets are formally the same: the fair values of a security and an insurance policy are the discounted expected values of the cash flows they provide their owners. Scholars and practitioners recognize these commonalities. Not surprisingly the markets have converged recently; for example, some insurance companies offer mutual funds and life insurance tied to stock portfolios, and some banks sell annuities.
FINANCIAL ECONOMICS WITH APPLICATIONS TO INVESTMENTS, INSURANCE AND PENSIONS 1 (Harry H. Panier, ed., 2001).

Insurance risk requires a fortuitous event or hazard and not a mere timing or investment risk. A fortuitous event[2] (such as a fire or accident) is at the heart of any contract of insurance. See

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[2] A happening that, because it occurs only by chance or accident, the parties could not reasonably have foreseen. Black's Law Dictionary, 725 (9th ed. 2009). See also, First Restatement of Contracts § 291, cmt. a (1932); American Law Institute, Restatement (Second) Contracts § 379, cmt. a (1981). See Generally, Jeffery W. Stempel, Stempel on Insurance Contracts, § 1.06A[4] (2007 Supp.) ("[I]n the past 20 years, a "modern" view of fortuity as a matter of law has emerged in United States courts, one that largely embraces the notions of fortuity held by the American Law Institute when it adopted the Restatement of Contracts, first in 1932 and again in the Second Restatement published in 1981."

Commissioner v. Treganowan, 183 F.2d 288, 290-91 (2d Cir. 1950) (the risk must contemplate the fortuitous occurrence of a stated contingency not an expected event).

Lack of Insurance Risk

The Service analyzed the risk of the contracts to determine whether the contracts qualify as contracts of insurance, annuity contracts or reinsurance contracts: In deciding whether the contracts qualify as insurance contracts for federal tax purposes, we have considered all of the facts and circumstances associated with the parties in the context of the captive arrangement. When deciding that a specific contract is not insurance because it does not have an insurance risk but deals with a business or investment risk, we have considered such things as the ordinary activities of a business enterprise, the typical activities and obligations of running of a business, whether an action that might be covered by a policy is in the control of the insured within a business context, whether the economic risk involved is a market risk that is part of the business environment, whether the insured is required by a law or regulation to pay for the covered claim, and whether the action is question is willful or inevitable.

20XX Policies

1. Special Risk - Loss of Services Insurance Policy

Covers the involuntary loss of service for key employees. The covered cause of loss must be involuntary and includes sickness, disability, death, loss of license, resignation or retirement after 14 days. Coverage does not include any loss of services if the insured terminated the employment of the employee. Also excluded is any claim if the insured does not attempt to replace the employee timely. Claims costs can include costs incurred by existing employees, costs of temporary employees, training costs, and lost net revenue.

Not insurance.

The policy is not insurance in the commonly accepted sense. Although a policy only covering death or disability of a key employee is insurance, the policy here covers many non-insurance risks, that is investment or business risks.

2. Special Risk – Product Recall

Covers the mandatory or voluntary recall of all products manufactured or sold by the Affiliated Business Interests in 20XX, due to a known or specific defect, deficiency of dangerous condition.

Not insurance.

The policy is not insurance in the commonly accepted sense. There is no insurance risk but only investment or business risk.

3. Special Risk – Weather Related Business Interruption

The policy covers loss of income from interruptions in business due to certain weather related events.

Insurance.

4. Special Risk—Regulatory Changes Insurance Policy

Covers actual compliance expenses and any business interruption loss up to 12 months as a result of any regulatory change that has an adverse impact on insured's normal on-going business operations. Regulatory changes include governmental, administrative agency, or legislative changes, changes to environmental, zoning, transportation, or safety laws or regulations, changes to import/export laws, regulatory changes due to foreign political risk including the collapse of a foreign economy, and any regulatory change due to the insured's reorganization, such as changing from a corporation to a limited partnership. The policy excludes any claim for an adverse regulatory change due to the insured's substantial non-compliance with regulations or other guidelines.
Not insurance.

The policy is not insurance in the commonly accepted sense. There is no insurance risk but only investment or business risk.

5. Special Risk—Tax Liability Insurance Policy

Covers any additional tax liability up to $0 subject to a deductible equal to 0% of the actual filed IRS tax liability provided return prepared and signed by CPA. Policy also covers defense expenses incurred in determining the final tax liability. Several IRS penalties are excluded from coverage.

Not insurance.

The policy is not insurance in the commonly accepted sense. There is no insurance risk but only investment or business risk.

6. Special Risk—Punitive Wrap Liability Insurance Policy

Covers claims for punitive or exemplary damages upon the failure of the insurer under policies listed that are issued to the insured to cover punitive or exemplary damages, judgments, or awards solely due t the enforcement of any law or judicial ruling that precludes the insuring of punitive or similar damages and that but for such law or ruling would otherwise be covered, and for which an insured is legally obligated to pay. The schedule of covered policies lists the other 9 direct written policies described in this part of this report.

Not insurance.

The policy is not insurance in the commonly accepted sense. There is no insurance risk but only investment or business risk.

7. Excess Pollution Liability

Insuring Agreement 1 and 2 cover clean-up costs and diminution in value costs resulting from pre-existing or new on-site pollution conditions. Coverage is conditioned on an affirmative obligation to report on site pollution conditions to a governmental agency so as to be in compliance with environmental laws. Various laws covering solid waste disposal, super funds, clean air, clean water, and toxic substances are listed in a non-exclusive list provided the insured has or may have a legal obligation to incur clean up costs for pollution conditions or pollution release. Clean up costs cover the expenses of investigation or removal of, or rendering non-hazardous pollution conditions to the extent required by environmental laws. Diminution in value means the difference in the fair market value of the property when the remedial action plan is approved and the fair market value of the property had there been no on site pollution conditions.
Insuring Agreements 3 to 12 provide for third party claims for on site or off site clean up and diminution in value costs for pre-existing or new on site or off site pollution conditions, as well as bodily and property damage, as well as non-owned locations.

Insuring Agreement 0 covers pollution release from transported cargo carried by covered autos. No covered auto is identified in the declarations.

Insuring Agreement 0 covers third party claims from transporting of a product or waste.

Insuring Agreement 0 covers actual loss resulting from the interruption of the business operations caused solely and directly by on site pollution conditions. Actual loss means the net income the insured would have earned had there been no interruption. Coverage also includes loss of rental value, which generally means the anticipated rental income from tenant occupancy of insured property.

Not insurance. The policy is not insurance in the commonly accepted sense. There is no insurance risk but only investment or business risk.

8. Special Risk – Loss of Major Customer

Covers any Business Interruption suffered as a result of losing the service of a Major Customer(s). Business Interruption includes the impact of lost revenue and the extra expenses involved in finding a replacement customer(s). The policy will not cover the voluntary loss of a Major Customer where the insured initiates the termination of the agreement; the loss of a Major Customer that insured did not attempt or intent to replace; or the loss of a Major Customer due to insured's substantial non-compliance with the terms and conditions of its contractual agreement with the customer.

Not Insurance. The policy is not insurance in the commonly accepted sense. There is no insurance risk but only business risk.

9. Excess Intellectual Property Package Policy

Insuring Agreement 1: Covers, damages, defense expenses, and compliance redesign expense for listed wrongful acts: infringement of copyrights, trademark etc; plagiarism or unauthorized use of ideas characters, plots etc; invasion of privacy or publicity; libel, slander, or product disparagement; piracy or unfair competition, misappropriation of advertising ideas, etc; breach of contract resulting from the alleged submission of material used by insured; patent infringement; malicious prosecution with regard to intellectual property. Compliance redesign expense covers expense to recall and/or redesign the insured's intellectual property to comply with a judgment or settlement. The policy excludes any intentional act by a director, officer or employee.
Insuring Agreement 2: Covers wrongful acts (listed above) committed by third parties against insured's intellectual property. It pays for litigation expenses, mitigation expense to mitigate the extent of the claim, costs to replace, restore, or re-create the covered intellectual property, and finally additional damages to the insured's business operations such as business interruption, loss of clients or market share, or public relations damage control efforts. The policy excludes loss due to insured's cyber presence.

Not insurance.

Insuring Agreement 1 and 2 are not insurance in the commonly accepted sense. There is no insurance risk but only investment or business risks. (It is not clear what intellectual property the insured possesses.)

10. Special Risk - Expense Reimbursement Insurance Policy

Coverage Form A deals with crisis management public relations expenses. This covers all public relations expenses to mitigate the insured's adverse publicity generated from an actual or imminent; liability incident that could exceed $0; product recall; employee layoff or labor dispute; government litigation; financial crisis; loss of intellectual property rights; unsolicited takeover bid; security incident; or any incident expected to reduce annual gross revenue by at least 0%.

Coverage Form B deals with uninsured defense. This covers all defense expense for actual or alleged civil liability where there is no insurer to provide such coverage or where such coverage has been exhausted under an existing insurance contract.

Not insurance as to Coverage A. Coverage Form A is not insurance in the commonly accepted sense. There is no insurance risk but only investment or business risk.

Coverage B may be insurance in the commonly accepted sense. It is vague as to what liability/contract underlies the need for defense expenses. More information needed as to Coverage B.

11. Excess Employment Practices Liability

Covers 11 categories of wrongful acts including wrongful termination, refusal to hire or promote, sexual harassment, unlawful discrimination based on age, gender, etc., invasion of privacy, failure to create employment policies or procedures, retaliatory treatment, violation of civil rights, violation of Family and Medical Leave Act, breach of employment contract, failure to provide safe work environment, violations listed herein against a non-employee. There is excluded from coverage claims related to employee's entitlements under various listed non-specific laws, rules or regulations. Also excluded are claims under various listed laws such as the Occupational Safety and Health Act. These exclusions shall not apply to claim for any actual or alleged retaliatory, discriminatory, or other employment practices-related treatment.

Not insurance. Policy is not insurance in its commonly accepted sense. There is no insurance risk but only investment or business risk.

12. Excess Directors & Officers Liability Insurance Policy

Covers wrongful acts or directors and officers.

Insurance.

13. Excess Cyber Risk

Insuring Agreement 1 – Cyber Risk Liability covers all damages that insured becomes legally obligated to pay and defense expenses as a result of any claim made against insured for a Wrongful Act. Wrongful Acts may include, but are not limited to the following: defamation;

infringement of intellectual property; and failure to prevent unauthorized access to, use of, tampering with, or introduction of malicious code into data or systems.

Insuring Agreement 2 – 1st Party Property Loss & Business Interruption covers loss of or damages to insured's covered property caused by, but not limited to the following: a computer virus; a cyber attack, theft of computer system resources; and computer crimes. Insuring Agreement 2 also covers business interruption expenses, monies surrendered or costs incurred as a result of Cyber-Extortion, and reward money for information leading to the arrest and conviction of individuals committing or attempting to commit illegal acts related to coverage under the policy.

Insuring Agreement 3 – Post-Loss Systems Crisis Management covers the cost of public relations services required to protect insured's image and reputation following a covered loss. Insuring Agreement 3 also covers service fees of consultants hired to identify and/or implement ways to prevent or decrease the possibility of a further or future loss similar to the covered loss.

Insuring Agreement 1 and 2 is insurance.

Insuring Agreement 3 is too vague and broad and not insurance in the commonly accepted sense. There is no insurance risk but only business risk.

Not insurance.

The policy is not insurance in the commonly accepted sense. There is no insurance risk but only investment or business risk.

<u>20XX Policies</u>

1. Loss of Services Insurance Policy

Same as 20XX. Not insurance.

2. Special Risk – Product Recall

Same as 20XX. Not insurance.

3. Special Risk—Regulatory Changes Insurance Policy

Same as 20XX. Not insurance.

4. Special Risk- Tax Liability

Same as 20XX. Not insurance.

5. Special Risk – Punitive Wrap

Same as 20XX. Not insurance.

6. Excess Pollution Liability Insurance Policy

Same as 20XX. Not insurance.

7. Special Risk – Loss of Major Customer

Same as 20XX. Not insurance.

8. Excess Intellectual Property

Same as 20XX. Not insurance.

9. Expense Reimbursement Insurance Policy

This policy differs from the 20XX insurance policy with the same title. Covers losses due to an actual or imminent liability incident, product recall, employee layoff or labor dispute.

Not insurance.

The policy is not insurance in the commonly accepted sense. There is no insurance risk but only investment or business risk.

10. Excess Directors & Officers Liability Insurance Policy

Same as 20XX. Insurance.

11. Expense Reimbursement—Legal Expenses Insurance Policy

Form 886-A (Rev. January 1994)	EXPLANATIONS OF ITEMS	Schedule number or exhibit
Name of taxpayer ORG	Tax Identification Number	Year/Period ended 12/31/20XX 12/31/20XX 12/31/20XX

New policy for 20XX. Policy covers litigation expenses from actual or alleged civil liability.

Not insurance.

This is not insurance in the commonly accepted sense. There is no insurance risk but only investment or business risk.

20XX Policies

Same 11 direct written contracts were issued to the Affiliated Business Interests in 20XX as in 20XX.

Therefore, only the Excess Directors & Officers Liability contract was deemed to be a valid insurance contract for 20XX.

Other Insurance Policies

CO-10.

CO-6 participated in over 0 insurance policies with more than 0 insureds. CO-6 blended together its direct written insurance and then reinsured the entire book on a quota share basis with each of the pool participants. Taxpayer was one of 0 reinsurers listed in the agreement for 20XX. As Reinsurer No. in the 20XX reinsurance program, Taxpayer received % of CO-6's gross premiums of $0, in exchange for the assumption % of the risk pool comprised of the stop loss coverage issued to all of the stop loss endorsement policyholders.

In 20XX, CO-6 participated in over 0 insurance policies with more than 0 insureds. CO-6 blended together its direct written insurance and then reinsured the entire book on a quota share basis with each of the pool participants. Taxpayer was one of 0 reinsurers listed in the agreement for 20XX. As Reinsurer No. 0, Taxpayer received 0% of CO-6's gross premiums of $0, in exchange for the assumption of 0% of the risk pool comprised of the stop loss coverage issued to all of the stop loss endorsement policyholders.

Finally, in 20XX, CO-6 participated in over 0 insurance policies with more than 0 insureds. CO-6 blended together its direct written insurance and then reinsured the entire book on a quota share basis with each of the pool participants. Taxpayer was one of 0 reinsurers listed in the agreement for 20XX. As Reinsurer No. 0, Taxpayer received 0% of CO-6's gross premiums of $0, in exchange for the assumption of 0% of the risk pool comprised of the stop loss coverage issued to all of the stop loss endorsement policyholders.

We do not have any understanding of the risks insured by Taxpayer. We do not know whether the policies "reinsured" are similar to the several policies that we have concluded above are not insurance. However, the direct written contracts insured by CO-6 do include the 0 contracts written by ORG Therefore, it is highly likely that the entire pool, which is insured by CO-6 and reinsured on a quota share basis with each of the pool participants, is primarily comprised of direct written contracts that the Service would deem not be insurance in the commonly accepted sense. Thus all or a portion of the premiums received by taxpayer, during the taxable years under consideration, would not be for reinsuring insurance risks.

Credit Coinsurance Reinsurance Program.

The policy reinsures risks on vehicle service contracts. Again, we do not know what risks are being insured and reinsured.

Pricing of Contracts

The Service also has concern about whether the premiums charged for the contracts were reasonable. A premium for an insurance contract is based on actuarial calculations and factors. Even if an insurance contract is deem to be "insurance" for federal tax purposes, the premium paid pursuant to that contract must be determined based on actuarial factors and principles. In the February 10, 20XX response to IDR #4 for 20XX, the CPA provided a copy of letters from CO-13; CO-11; and CO-12, which was purpose to address the method used for pricing the direct written and reinsurance contracts for the taxable years under consideration. However, the Service concluded that the letters did not address the method of pricing the specific direct written and reinsurance contracts that ORG was a party to during 20XX, 20XX, and 20XX. Thus, the Service concluded that the premiums received by taxpayer were not reasonable because they were not based on actuarial calculations and factors.

Risk Shifting

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. See Rev. Rul. 60-275 (risk shifting not present where subscribers, all subject to the same flood risk, agreed to coverage under a reciprocal flood insurance exchange).

Risk Distribution

Risk distribution incorporates the statistical phenomenon known as the law of large numbers. The concept of risk distribution "emphasizes the pooling aspect of insurance: that it is the nature of an insurance contract to be part of a larger collection of coverages, combined to distribute risks between insureds." AMERCO and Subsidiaries v. Commissioner, 96 T.C. 18, 41 (1991), aff'd, 979 F.2d 162 (9th Cir. 1992). In Treganowan, 183 F.2d at 291, the court quoting Note, The New York Stock Exchange Gratuity Fund: Insurance That Isn't Insurance, 59 Yale L.J. 780, 784 (1950), explained that "by diffusing the risks through a mass of separate risk shifting contracts, the insurer casts his lot with the law of averages. The process of risk distribution, therefore, is the very essence of insurance." Also see Beech Aircraft Corp. v United States, 797, F.2d 920, 922 (10th Cir. 1986), (risk distribution "means that the party assuming the risk distributes his potential liability, in part, among others"); Ocean Drilling & Exploration Co. v. United States, 988 F.2d 1135, 1135 (Fed. Cir. 1993) ("risk distribution involves spreading the risk of loss among policyholders").

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 over time, the insurer smoothes out losses to match more closely its receipts 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 Situation 1 of Rev. Rul. 2002-89, S, a wholly owned subsidiary of P, a domestic parent corporation, entered into an annual arrangement with P whereby S provided coverage for P's professional liability risks. The liability coverage S provided to P accounted for 90% of the total risks borne by S. Under the facts of Situation 1, the Service concluded that insurance did not exist for federal income tax purposes. On the other hand, in Situation 2 of Rev. Rul. 2002-89, the premiums that S received from the arrangement with P constituted less than 50% of total premiums received by S for the year. Under the facts of Situation 2, the Service reasoned that the premiums and risks of P were pooled with those of unrelated insureds and thus the requisite risk shifting and risk distribution were present. Accordingly, under Situation 2, the arrangement between P and S constituted insurance for federal income tax purposes.

In Rev. Rul. 2002-90, 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 and there were no related guarantees of any kind in favor of S. 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. Together, the 12 operating subsidiaries had a significant volume of independent, homogeneous risks. Under the facts presented, the ruling concludes the arrangement between S and each of the 12 operating subsidiaries of the parent of S constitute insurance for federal income tax purposes.

Situation 1 of Rev. Rul. 2005-40, describes a scenario where a domestic corporation operated a large fleet of automotive vehicles in its courier transport business covering a large portion of the United States. This represented a significant volume of independent, homogeneous risks. For valid non-tax business purposes, the transport company entered into an insurance arrangement with an unrelated domestic corporation, whereby in exchange for an agreed amount of "premiums," the domestic carrier "insured" the transport company against the risk of loss arising out of the operation of its fleet in the conduct of its courier business. The unrelated carrier received arm's length premiums, was adequately capitalized, received no guarantees from the courier transport company and was not involved in any loans of funds back to the transport company. The transport company was the carrier's only "insured." While the requisite risk-shifting was seemingly present, the risks assumed by the carrier were not distributed among other insured's or policyholders. Therefore, the arrangement between the carrier and the transport company did not constitute insurance for federal income tax purposes.

The facts in Situation 2 of Rev. Ruling 2005-40 mirror the facts of Situation 1 except that in addition to its arrangement with the transport company, the carrier entered into a second arrangement with another unrelated domestic company. In the second arrangement, the carrier agreed that in exchange for "premiums," it would "insure" the second company against its risk of loss associated with the operation of its own transport fleet. The amount that the carrier received from the second agreement constituted 10% of the total amounts it received during the tax year on a gross and net basis. Thus, 90% of the carrier's business remained with one insured. The revenue ruling concluded that the first arrangement still lacked the requisite risk distribution to constitute insurance even though the scenario involved multiple insureds.

In Situation 4 of Rev. Rul. 2005-40, 12 LLC's elected classification as associations, each contributing between 5 and 15% of the insurer's total risks. The Service concluded that this transaction constituted insurance for federal income tax purposes.

The principal concern with regard to your activities is whether there is sufficient risk distribution. As discussed above, the idea of risk distribution involves some mathematical concepts. For example, risk distribution is said to incorporate the statistical phenomenon known as the "law of large numbers" whereby distributing risks allows the insurer to reduce the possibility that a single costly claim will exceed the amount taken in as premiums. The concept hinges on the assumption of "numerous relatively small" and "independent risks" that "occur randomly over time." Clougherty Packing Co., 811 F.2d 1297 at 1300.

As discussed, the Service in Rev. Rul. 2002-90, concluded that insurance existed where 12 insureds each contributed between five and 15% to the insured's total risks. Similarly, in Situation 4 of Rev. Rul. 2005-40, the Service concluded that insurance existed where 12 LLCs, electing classification as associations, each contributed between five and 15% of the insurer's total risks. Moreover, in Situation 2 of Rev. Rul. 2002-89, supra, the Service concluded that insurance existed where a wholly owned subsidiary insured its parent, but the arrangement represented less than 50% of the insurer's total risk for the year.

In the instance case, the facts therein are analogous to the analysis under Situation1 of Rev. Rul. 2002-89, supra, the liability coverage provided to the parent corporation by its wholly owned subsidiary accounted for 90% of the total risks borne by the subsidiary. Similarly, in Situation 2 of Rev. Rul. 2005-40, supra, a second insurer contributing 10% of the insured's risks was added to the single-insured scenario of Situation1. The Service concluded in both of the above scenarios that insurance did not exist because there lacked a sufficient number of insureds. The small number of insureds produced an insufficient pool of premiums to distribute any insurance risk.

With respect to the contracts reviewed during the tax year under audit, the Service concluded that the agreements between the taxpayer and the Affiliated Businesses, CO-2., CO-3, and CO-4, the insured, did not constitute contracts of insurance because they lack the essential element of risk distribution. Most of the risk insured by the taxpayer is under the direct written contracts with related entities. All of total risk insured by the company, approximately 0% to 0% of the risk is from the related entities. The taxpayer did not write or issue separate contracts to the affiliated insured. In addition, of the total premiums received during the years under audit, 100% of the direct written premium (and 0% to 0% of total premiums) was paid by a single entity, CO-2., even though the direct written contracts covers all three related insured. There is no evidence that each of the related insured paid separate premiums to ORG for its coverage. Nor did the parties have an agreement showing the amount of premium allocable to each of insured. Even if related of affiliated insured did pay premiums separately to the taxpayer, the fact pattern still would not create a pool large enough to adequately distribute the taxpayer's risk. Rev. Rul. 2005-40 cited several court decisions that 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. In this case, the large concentration of insurance risks in one insured does not constitute risk distribution because of the very high likelihood of the insured paying for any of its claims with its own premiums. Such an arrangement is not insurance but a form of self-insurance.

The Service concluded that the contracts resulted in risk that was too heavily concentrated in the three related insured. Because the risk was heavily concentrated in the Affiliated Businesses, it is highly probable that any losses paid by the taxpayer are those of the Affiliated Businesses and not from an unrelated third party. In addition, since the Affiliated Businesses paid the majority of premiums received by the taxpayer during the year under audit, the Service concluded that losses incurred by the Affiliated Businesses were paid from the premiums paid to the taxpayer by the Affiliated Businesses. In other words, the arrangement between the taxpayer and the Affiliated Businesses represented a form of self-insurance, and no court has held that self-insurance is insurance for federal tax purposes.

Also, an arrangement that provides for the reimbursement of believed-to-be inevitable future costs does not involve the requisite insurance risk for purposes of determining whether the assuming entity may account for the arrangement as an "insurance contract" for purposes of Subchapter L of the Internal Revenue Code.

Furthermore, it appears that the various risks insured are not homogeneous, and thus, must be separated from one another and analyzed separately as to whether there is risk distribution as to that risk. See. Rev. Rul. 2002-89, supra; also see Rev. Rul. 2005-40.

Assuming that all of the agreements do constitute insurable risks or that a significant majority of the contracts qualify as insurable risks, over 0% of the total risks assumed by the company are with affiliated entities that are owned and controlled by Owner and Co-Owner, the beneficial owners of the taxpayer.

Gross Receipts Test

Section 501(c)(15) of the Internal Revenue Code provides exemptions for insurance companies, other than life insurance companies (including inter-insurers and reciprocal underwriters), if the gross receipts for the taxable year do not exceed $600,000, and more than 50% of such gross receipts consist of premiums.
Based the Service's analysis of the contracts, twelve of the fourteen direct written contracts were deemed not to be insurance (or we could definitively determine whether the contract included an insurance risk). Therefore, the amounts received by ORG for those twelve direct written contracts are not considered insurance premiums. Amounts received by taxpayer for two of the fourteen direct written contracts were deemed to be premiums because only for those contracts included an insurance risk. During the taxable years under consideration, ORG received amounts that the Service deemed to be direct written and reinsurance premiums as follows:

20XX

Contract	Premium
Special Risk – Weather Related Business Interruption	$ 0
Excess Directors & Officers Liability	0
Amount Deemed Premiums from Direct Written Contracts	$ 0
Quota Share Premiums	0
Credit Coinsurance Reinsurance	0
Total Premiums for 20XX	$ 0
Gross Receipts for 20XX	0
Percentage of Premiums to Gross Receipts	0%

20XX

Contract	Premium
Excess Directors & Officers Liability	$ 0

Form 886-A (Rev. January 1994)	EXPLANATIONS OF ITEMS	Schedule number or exhibit
Name of taxpayer ORG	Tax Identification Number	Year/Period ended 12/31/20XX 12/31/20XX 12/31/20XX

Amount Deemed Premiums from Direct Written Contracts	$	0
Quota Share Premiums		0
Credit Coinsurance Reinsurance		0
Total Premiums for 20XX	$	0
Gross Receipts for 20XX	$	0
Percentage of Premiums to Gross Receipts		0%

20XX

Contract		Premium
Excess Directors & Officers Liability	$	0
Amount Deemed Premiums from Direct Written Contracts	$	0
Quota Share Premiums		0
Credit Coinsurance Reinsurance		0
Total Premiums for 20XX	$	0
Gross Receipts for 20XX	$	0
Percentage of Premiums to Gross Receipts		0%

The amounts received by ORG under the remaining direct written contracts were not premiums for insurance contracts in the commonly accepted sense. The terms of the contracts did not include insurance risk but covered investment or business risks. The remaining contracts lacked the requisite insurance risk to constitute insurance because the contracts lacked fortuity, and the risk at issue is akin to the timing and investment risks of Rev. Rul. 89-96.

An arrangement that provides for the reimbursement of believed-to-be inevitable future costs does not involve the requisite insurance risk for purposes of determining whether the assuming entity may account for the arrangement as an "insurance contract" for purposes of Subchapter L of the Internal Revenue Code. For the contracts that are deemed not to qualify as insurable risks, then the amount paid for each contract, by CO-2. to the TP, would not qualify as an insurance premium.

In addition, although we question whether the CO-10 contracts are actually valid reinsurance contracts, and whether the amounts received by taxpayer under the contracts are valid reinsurance premiums, the amounts received by taxpayer from CO-6 Insurance Company were included as "premium income" for purposes of the gross receipts computation shown above. Even after given the taxpayer the benefit of the doubt, the taxpayer still failed the gross receipts for the years under audit.

During the tax years under consideration, the premium income received by taxpayer did not exceed % of its gross receipts. Although gross receipts are less than the $ limitation, the amount deemed to be premiums, for each taxable year, is not more than % of gross receipts. Therefore, we are revising our position on the gross receipts test as stated in our Preliminary Report issued to taxpayer on September 26 20XX. Based on further analysis of the contracts, we concluded that the taxpayer did not meet the % gross receipts test described in IRC 501(c)(15) and Notice 2006-42 for any tax year under audit.

As described in Situation 1 of Rev. Rul. 2002-89, supra, and Situation 2 of Rev. Rul. 2005-40, supra, there exists an inadequate premium pooling base for insurance to exist. The addition of the two other reinsurance arrangements does not change the conclusion that the contracts with the Affiliated Business Interests lack the requisite risk distribution. Therefore, the taxpayer does not qualify as an insurance company.

Application of Foreign Corporation Tax Provisions

The administrative file for the original Form 1024 application filed by ORG included a copy of the IRC 953(d) election filed by the Company on February 23, 20XX. However, the IRS has no record that the election was approved. In the July 28, 20XX response to Information Document Request #2, issued by the examining agent on April 28, 20XX, , CPA, stated that it is her understanding that the Internal Revenue Service recently changed its internal procedures to postpone review of an IRC 953(d) election until the Form 1024 application was reviewed. It appears that the Service still has not completed processing the IRC 953(d) election filed years ago. ORG withdrew the initial Form 1024 application on September 16, 20XX.[3]

IRC 953(a)(1) defines insurance income to mean income which is attributable to the issuing or reinsuring of an insurance or annuity contract, and would be taxed under subchapter L if such income were the income of a domestic insurance company. Therefore, any premium income received by a CFC could qualify

IRC 953(d) allows foreign insurance company to elect to be treated as a domestic company for tax purposes if it meets certain requirements. One such requirement is that the foreign company must be a company that would qualify under part I or II of subchapter L for the taxable year if it were a domestic corporation. See IRC 953(d)(1)(B).

Since the Service determined that the taxpayer is not an insurance company within the meaning of Subchapter L of the Code for the year under audit, it fails to meet the requirements for the election under IRC 953(d) to be treated as a domestic corporation.

In addition, because the company does not meet the requirements to make the IRC 953(d) election, and thus, is not a domestic corporation, the company should be treated as a "controlled foreign corporation," and the provisions of Subpart F of the Internal Revenue Code (sections 951-965) should apply. However, the Company did not generate any passive

[3] Taxpayer filed a new Form 1024 application with Rulings and Agreements in September 20XX.

sources of income such as dividends, interest, royalties, rents or annuities, during the tax year under audit.

The subpart F provisions apply to foreign corporations that qualify as controlled foreign corporations ("CFCs"). IRC 957 defines a CFC as a foreign corporation with regard to which more than % of the total combined voting power of all classes of stock entitled to vote or the total value of the stock is owned by U.S. shareholders. A U.S. shareholder, in turn, is defined under IRC 951(d) as a U.S. person who owns % or more of the total combined voting power of all classes of stock entitled to vote of the foreign corporation. Therefore, a corporation with regard to which more than % of the vote or value is owned by U.S. persons who individually own % or more or the vote will qualify as a CFC under IRC 957.

IRC 953(a)(1) defines insurance income to mean income which is attributable to the issuing or reinsuring of an insurance or annuity contract, and would be taxed under subchapter L if such income were the income of a domestic insurance company. Therefore, any premium income received by a CFC could qualify as insurance income for purposes of IRC 953 even though the CFC fails to qualify as an insurance company under subchapter L.

IRC 953(a)(2) of the Code excepts "exempt insurance income (as defined in subsection (e)" from the definition of insurance income. However, to qualify as exempt insurance income, such income must be derived by a qualifying insurance company. A qualifying insurance company is defined as a company that "is engaged in an insurance business and would be subject to tax under subchapter L if it were a domestic corporation.

IRC 953(e)(3)(C) states that income derived from U.S. sources does not qualify for exemption.

If a CFC does not qualify as an insurance company under subchapter L,.it will not meet the definition of a qualifying insurance company for purposes of IRC 953(e). Thus, none of its insurance income will be exempt insurance income.

A Preliminary Report, Form 5701, *Notice of Proposed Adjustments*, was mailed to the taxpayer's CPA, , on September 26, 20XX, proposing denial of tax-exempt treatment under section 501(c)(15) of the Internal Revenue Code, for the tax years ending December 31, 20XX, December 31, 20XX, and December 31, 20XX.

Finally, the Government contends that although the operations and financial records for the tax years subsequent to 20XX were not examined by TEGE, the taxpayer would also fail to qualify an insurance company for any future year, if taxpayer operated in the same manner as that during the years audited.

TAXPAYER'S POSITION:

A response to the Preliminary Report was received from CPA, CPA, on November 12, 20XX. In the response, the CPA summarized that the taxpayer disagreed with the Service's conclusion that the contracts issued by ORG lack adequate risk distribution, and that ORG's primary and predominant business is insurance; ORG qualifies for IRC 501(c)(15) tax-exempt status; and ORG is not a controlled foreign corporation.

The CPA argued the following points:

1. The Service's incorrect conclusion is based solely upon its unsupported position that ORG's insurance operations lacked the requisite risk distribution. In reaching its incorrect conclusion that ORG's insurance operations lacked the requisite risk distribution, the Service ignored more than thirty years of well-established tax law, as well as hundreds of prior favorable rulings issued by the Service.

2. The taxpayer indicated that "in analyzing captive insurance arrangements for the presence of risk distribution, courts have looked at the level of unrelated risk as a metric for the presence of risk distribution." The Service ignores the Tax Court ruling in *The Harper Group and Includible Subs. v Commissioner*, 96, T.C. 45 (1991), aff'd979 F.2d 1342 (9th Cir. 1992), where 30% unrelated risks was determined to be sufficient to meet the risk distribution requirement.

3. The taxpayer stated that the Service conducted no meaningful examination of risk distribution in its audit of ORG. Rather, the Service simply claims that the direct written contracts lack the requisite risk distribution. The nature of insurance is the number of underlying risk exposures present, not an artificial entity count or an artificial count of the number of policies written. The Taxpayer cites *AMERCO, Inc. v. Commissioner*, No. 91-70732, slip op. 13187 (9th Cir. Nov. 5, 1992).

4. The taxpayer argues that the 30% outside business principle and the decision in *Harper* are recognized in the Service's own Foreign Insurance Excise Tax Audit Technique Guide.

5. The Service appears to ignore Revenue Ruling 2001-31, in which the Service conceded that it would no longer assert the economic family theory due to its rejection by the courts.

6. The taxpayer argues risk distribution can occur even with a single insured. The taxpayer cited, *Malone & Hyde v. Commissioner*.

7. Rather than engage in a meaningful analysis of the number of independent risk exposures insured by ORG, the Service merely asserts that risk distribution is lacking. The Service has recognized the principle of looking-through the insurance policy to the actual risks insured in several revenue rulings. See Rev. Rul. 2009-26, Rev. Rul. 92-93, and Rev. Rul. 80-95.

8. Taxpayer argues the Service's current position is directly contrary to the position it has taken in hundreds of prior Section 501(c)(15) tax-exempt determination letters that it has issued. These favorable rulings were issued to taxpayer on substantially similar, or less favorable, facts to those of ORG. There has been no intervening change in law to account for the Service's disparate tax treatment between ORG and such similarly situated taxpayers. Accordingly, the Service has violated its own procedures and mandate to provide a uniform application of existing tax law (Rev. Proc. 2012-9).

9. Taxpayer argues that it qualifies for tax-exempt status as an insurance company described in IRC 501(c)(15) during all of the years under review. Taxpayer made a valid election under IRC Section 953(d) to be treated as a domestic corporation, and the Service's conclusion that the taxpayer is a controlled foreign corporation is incorrect.

Government's Response to Taxpayer's Position:

After reviewing the response to the Preliminary Report received from , CPA, on November 12, 20XX, the Service's initial position is unchanged. ORG's primary and predominant business in tax years 20XX, 20XX, and 20XX, was not insurance because the contracts issued by the company lacked the requisite risk distribution.

Taxpayer's Position:

In the initial paragraph of the November 12, 20XX response to the agent's preliminary report, the CPA stated that the audit conclusion reached by the Service was solely based on an unsupported position that ORG's insurance operations lacked the requisite risk distribution.

Government's Response:

The conclusion reached by the Service was based on an examination of the direct written and reinsurance contracts executed by ORG, and books and records for the 20XX, 20XX, and 20XX tax years. Based on the review of the contracts, the Service concluded that the primary activity of ORG was to assume risks of affiliated businesses owned and controlled by officers of ORG and beneficial owners of the affiliated businesses. Approximately 0% of the risk assumed by ORG was that of the affiliated businesses. ORG did not assume risk of or receive premiums from non-affiliated businesses or unrelated general public under the terms of the direct written contracts. The Service concluded that the direct written contracts lack the requisite risk distribution because arrangement does not include an adequate pool of related or unrelated insured for the law the large numbers to operate. The pool consisted of a single policyholder and payer of direct written premiums. Thus, ORG's primary and predominant activity is not insurance as described in Subchapter L of the Internal Revenue Code.

<u>Taxpayer's Position</u>:
On page 2 of the Taxpayer's position, the CPA cites the *Harper Group & Subsidiaries v. Commissioner*, 96 T.C. 45 (1991) to support the argument that ORG qualifies as an insurance company. The CPA sites the court's holding, when a significant percentage (29 percent) of an insurance company's income is received from a relatively large number of unrelated insureds, the requirement of risk distribution is satisfied. The source of the remaining 71 percent is irrelevant on the issue whether sufficient risk distribution is present because of the significant presence of unrelated risks. The CPA made the following statement in paragraph 2 on page 2 of the November 12, 20XX response:

> In its preliminary report, the Service merely states, that due to 0 percent of premiums being direct written premiums paid by certain insureds that owned no interest in ORG, there is a lack of adequate risk distribution. This ignores the fact that more than 0 percent of premiums were attributable to unrelated insurance arrangements involving many thousands of independent, unrelated risks of hundreds or thousands of unrelated insureds.

<u>Government's Response</u>:
The Service disagrees with the CPA's assertion that the determining factor of whether the requisite risk distribution is present is identifying the percentage of business with unrelated insureds. Instead, the current Service's position on captive insurance arrangements is expressed in Revenue Ruling 2005-40, which emphasizes the number of policyholders and percentage of business with the related or affiliated insureds as the determining factor of whether risk distribution is present. The Rev. Rul. emphasizes that an arrangement where an issuer received premiums from a single policyholder lacks the requisite risk distribution. The ruling further emphasized that an issuer with contracts with a small number of policyholders can be insurance if the percentage of business exceeds 50 percent of the total insurance business conducted.

Even if the CPA claimed that insurance exists under the rationale in the Harper case, where approximately 30% of the risk assumed by ORG was from unrelated or unaffiliated insured, the Service believes that this conclusion would be based on a misunderstanding of the Harper Case. In the Harper Case, 67% to 71% of the total premiums received for the years at issue were not related to a single policyholder. Rather, the 67% to 71% were the total percentages received from all related policyholders, including brother-sister corporations (a total of 13 entities). The court's analysis in Harper Group must be read in its entirety and all the facts and circumstances must be considered, i.e. that there are 13 entities making up the nearly two thirds risk concentration in all the years at issue.

The Service's interpretation of the Harper Group is consistent with the conclusions reached by the Service in Situation 2 of Revenue Ruling 2002-89 and Situation 4 of Revenue Ruling 2005-40.

Taxpayer's Position:
On page 3, paragraph 4, the CPA stated that in reaching its incorrect conclusion in the preliminary report, the Service appears to ignore Revenue Ruling 2001-31, in which the Service conceded that it would no longer assert the economic family theory due to its rejection by the courts.

Government's Response:
The current Service position is expressed in Ruling Revenue 2005-40, I.R.B. 2005-27 (June 17, 2005), which provides IRS issued guidance emphasizing that the requirement of risk distribution must be met. The ruling demonstrated that this risk distribution requirement cannot be satisfied if the issuer of the contract enters into such a contract with only one policyholder. If the contract fails to constitute insurance, then the premiums paid are not deductible business expenses under Code Sec. 162, and the issuing company is not an insurance company for federal tax purposes. Rev. Rul. 2005-40 cited several court decisions that 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. In this case, the large concentration of insurance risks in one insured does not constitute risk distribution because of the very high likelihood of the insured paying for any of its claims with its own premiums. Such an arrangement is not insurance but a form of self-insurance.

However, when the arrangements between the companies do constitute insurance for federal income tax purposes and assuming these arrangements represented more than 50 percent of the insuring company's business, the company will be an insurance company within the meaning of IRC Sections 816 and 831, and the premium payments may be deductible under Code Sec. 162, assuming the requirements for deduction are otherwise satisfied

Taxpayer's Position:
On page 4, paragraph 2, of the taxpayer's position, the CPA stated that the Service conducted no meaningful examination of risk distribution in its audit of ORG. Rather, the Service simply claims that the direct written contracts lack the requisite risk distribution. The nature of insurance is the number of underlying risk exposures present, not an artificial entity count or an artificial count of the number of policies written.

Government's Response:
In Question 7, of IDR #2, issued to the CPA on April 28, 20XX, an analysis of risk assumed by the taxpayer was presented by the examining agent to the CPA for comment. Under the terms of the contracts reviewed during the audit, ORG assumed risk exposures as follows:

Affiliated Interests	Direct exposure	0 %	0%
Affiliate Interests	Pooled reinsurance exposure	0	0
Unrelated & Affiliate Interests	Pooled reinsurance exposure	0	0
Total risk assumed		0%	0%

In the July 28, 20XX response to IDR #2, CPA, CPA, provided the following comments:[4]

> The percentages listed in your question are incorrect. The percentages set forth in IDR #2 were apparently derived from simply adding together the company's participation rates in various direct insurance and reinsurance contracts. This method does not take into account relative value of the different contracts and is, therefore, invalid. <u>The proper method for determining the amount of risk being assumed by the company is to compare the premiums received on the various contracts.</u> The Income Statement included under Tab 17 of the initial IDR response shows the following:

20XX		
Direct Written Premiums	$ 0	0%
Other Reinsurance Assumed	0	0%
Pooled Reinsurance Assumed	0	0%
Total	$ 0	0%

20XX		
Direct Written Premiums	$ 0	0%
Other Reinsurance Assumed	0	0%
Pooled Reinsurance Assumed	0	0
Total	$ 0	0%

20XX		
Direct Written Premiums	$ 0	0%
Other Reinsurance Assumed	0	0%
Pooled Reinsurance Assumed	0	0

[4] Only the premiums analysis was included in the RAR prepared by the examining agent.

Total	$ 0	0%

Based on the CPA's own statement, **the proper way to determine the percentage of risk assumed by the taxpayer is to compare the premium income received under the contracts issued.** Using this method, the Service concluded that the taxpayer's the primary and predominant activity conducted is assuming risk under the direct written contracts with the affiliated business interests, because the activity accounted for more than 50 percent of the business (and premiums) during the three years under audit.

Taxpayer's Position:

On page 4, paragraph 3, the CPA stated that the Service's position is directly contrary to the position it has taken in hundreds of prior Section 501(c)(15) tax-exempt determination letters that it has issued. These favorable determination letters were issued to taxpayers substantially similar, or less favorable, facts to those of ORG. There has been no intervening change in law to account for the Service's disparate tax treatment between ORG and such similarly situated taxpayers. Accordingly, the Service has violated its own procedures and mandate to provide a uniform application of existing tax law. See Rev. Rul. 2012-9, Section 9.

Government's Response:

The Service's current position on captive arrangements is expressed in Revenue Ruling 2005-40, I.R.B. 2005-27 (June 17, 2005). Although the service has issued favorable rulings to similar captive arrangements in the past, many of the rulings were issued prior to the publishing of Revenue Ruling 2005-40, and subsequent clarification of the revenue ruling received from the Office of Chief Counsel.

In addition, the Service is not precluded from proposing denial of IRC 501(c)(15) tax-exempt status to ORG simply because the Service issued favorable ruling letters to other applicants in the past.

Furthermore, the Service was not provided adequate opportunity to rule on the taxpayer's Form 1024 application filed with Rulings & Agreements in September 20XX, because the taxpayer withdrew the application, in September 20XX, before a final determination could be made by the Service.

Taxpayer's Position:

On page 5, paragraph 2, the CPA stated that ORG qualified for tax-exempt status as an insurance company described in IRC Section 501(c)(15) during all of the years under review. As ORG made a valid election under IRC Section 953(d) to be treated as a domestic corporation, the Service's conclusion that ORG is a controlled foreign corporation is incorrect.

Government's Response:

Form 886-A (Rev. January 1994)	EXPLANATIONS OF ITEMS		Schedule number or exhibit
Name of taxpayer ORG		Tax Identification Number	Year/Period ended 12/31/20XX 12/31/20XX 12/31/20XX

According to the Form 1024, Application for Recognition of Tax-Exempt Status, administrative file, the taxpayer filed its IRC 953(d) election with the Plantation, State office of the Service on February 23, 20XX.

IRS records reveal that the IRC 953(d) election was never approved by the Service because the taxpayer did not submit proof of IRC 501(c)(15) tax-exempt status. The taxpayer could not provide proof of IRC 501(c)(15) tax-exempt status because it did not complete the Form 1024 application process. The taxpayer withdrew its Form 1024 application on September 16, 20XX, after its Counsel anticipated that the Service would issue a final adverse ruling letter denying IRC 501(c)(15) exemption.

IRC 953(d) allows foreign insurance company to elect to be treated as a domestic company for tax purposes if it meets certain requirements. One such requirement is that the foreign company must be a company that would qualify as an insurance company, under part I or II of subchapter L, for the taxable year if it were a domestic corporation. See IRC 953(d)(1)(B).

Since the Service determined that the taxpayer is not an insurance company within the meaning of Subchapter L of the Code for the year under audit, it fails to meet the requirements for the election under IRC 953(d) to be treated as a domestic corporation.
In addition, because the taxpayer does not meet the requirements to make the IRC 953(d) election, and thus, is not a domestic corporation, the taxpayer should be treated as a "controlled foreign corporation," and the provisions of Subpart F of the Internal Revenue Code (sections 951-965) should apply.

CONCLUSION:

Because taxpayer did not qualify as an insurance company for federal income tax purposes, taxpayer failed to meet the requirements of section 501(c)(15) of the Code. Thus, taxpayer did not qualify for recognition of exemption under section 501(a) of the Code as an organization described in section 501(c)(15) of the Internal Revenue Code for the 20XX, 20XX, and 20XX tax years.

Since the IRC 953(d) election filed by taxpayer was not been approved by the IRS, the taxpayer should be treated as a controlled foreign corporation, and the subpart F provisions should apply.