Office of Chief Counsel
Internal Revenue Service
memorandum
CC:FIP:4SFLUM

date:

to: Robert C. Harper, Jr., Branch Chief, EO Rulings & Agreements, Branch 3 SE:T:EO:RA:T:3

from: Donald J. Drees, Jr., Acting Chief, CC:FIP:4

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subject: [redacted]
Technical Assistance Request
PRENO-114675-05

This memorandum responds to your request for technical assistance regarding the above company, dated March 14, 2005. You asked us to advise you as to whether [redacted] qualifies as an "insurance company" as defined under § 1.801-3(a)(1) of the Income Tax Regulations. We conclude, based on the information provided, that [redacted] cannot qualify as an insurance company for federal income tax purposes for [redacted] There is insufficient information in the file to make any determination as to whether [redacted] could qualify as an insurance company after [redacted]

Section 831 of the Code sets forth the rules governing the taxation of insurance companies other than life insurance companies. [redacted] states in its Form 1024 that it does not intend to sell life insurance products. Section 831, however, does not define what constitutes an insurance company. Treas. Reg. § 1.831-3(a) provides that for purposes of §§ 831 and 832, the term "insurance companies" means only those companies which qualify as insurance companies under former § 1.801-1(b), which is now § 1.801-3(a). Treas. Reg. § 1.801-3(a)(1) provides that the term "insurance company" means a company whose primary and predominant business activity during the taxable year is the issuing of insurance or annuity contracts or the reinsuring of risks underwritten by insurance companies. This section further provides that though the company's name, charter powers, and subjection to state insurance laws are significant in determining the business that a company is authorized and intends to carry on, it is the character of the business actually done in the taxable year that determines whether the company is taxable as an insurance company under the Code. See also, Bowers v. Lawyers Mortgage Co., 285 U.S. 182, 188 (1932); Rev. Rul. 83-172, 1983 C.B. 107.

To determine whether [redacted] qualifies as an insurance company we must consider all of the relevant facts, including but not limited to the size and activities of its

staff, whether it engages in other trades or businesses, and its sources of income. Based on the information [redacted] submitted, it appears that the relevant facts are as follows:

[redacted] was incorporated in the [redacted] [redacted] thereafter filed an election under § 953(d) to be treated as a U.S. domestic insurance company. [redacted] has also filed Form 1024, Application for Recognition of Exemption under Section 501(a), stating that it believes it meets the requirements of § 501(c)(15). While [redacted] Form 1024 does not indicate the tax period for which it seeks tax exemption, this omission is of no import since it does not appear that [redacted] can qualify as an insurance company for any tax year. [redacted] indicated that it intends to sell property and casualty insurance.

At incorporation, [redacted] was funded with a capital contribution of $[redacted] from its sole shareholder [redacted] [redacted] sold certain investment property to obtain these funds. While your memo indicates that [redacted] had gross income of $[redacted] for tax year [redacted], based on [redacted] § 953(d) election, this amount does not appear to be [redacted] actual gross income for [redacted] [redacted] has stated that for purposes of the § 953(d) election, it annualized its [redacted] income. Per [redacted] Form 990, Return of Organization Exempt from Income Tax, [redacted] had total revenue of $[redacted] for [redacted]. In an April 6, 2004, letter from [redacted] POA [redacted] [redacted] states that "[redacted] holds and will maintain readily liquid assets in the form of securities, certificates of deposits and cash. [redacted] will maintain a balanced long-term asset portfolio that will also consist of some real estate related investments."

[redacted] further states in the April 6, 2004, letter that [redacted] maintains one employee—its CEO [redacted] [redacted] purportedly retains an outside consultant and insurance manager, as well as an outside accountant, actuary, and bookkeeper. Per the file, throughout its existence, [redacted] has written only five contracts. [redacted] claims to be pursuing two niche lines of insurance business—[redacted] coverage and [redacted] coverage. [redacted] appears to intend to reinsure all policies it writes.

On [redacted], [redacted] wrote three Income Replacement Insurance Policies to persons unrelated to [redacted] The gross annual premiums for these contracts were $[redacted]. The maximum annual gross liability for all three contracts totaled $[redacted] However, also on [redacted] [redacted] reinsured a large portion of its liability under these three contracts. After reinsurance, [redacted] maximum annual net liability for all three contracts totaled $[redacted] The terms for these three contracts were for one year—meaning the contracts expired on [redacted] While there is no indication that the three contracts were renewed, [redacted] Form 990 for [redacted] shows accounts receivable of $[redacted] as of [redacted] Further, the [redacted] letter from [redacted] an actuarial consulting group hired by [redacted] seems to indicate that the three contracts, as well as the reinsurance, were in effect in [redacted]

On [redacted], [redacted] wrote one Professional Liability Insurance Policy for [redacted] This contract's term was one year. The aggregate liability limit for this contract is $[redacted] There is no indication that [redacted] has reinsured this contract. The information in the file predates [redacted] so there is no indication whether this contract was renewed.

On [redacted] [redacted] wrote an [redacted] for [redacted] is wholly owned by [redacted] sole owner. In addition, [redacted] While the contract in the file does not provide any details about the premium paid or the benefit amount, the letter from [redacted] (the actuarial consulting group hired by [redacted] states that they were provided with a copy of an [redacted] contract to be written by [redacted] The annual premium for this contract would be $[redacted] The contract would provide $[redacted] coverage with a $[redacted] deductible. There would be liability coverage limits of $[redacted] per person and $[redacted] per occurrence. There is no evidence that the actual contract [redacted] sold to [redacted] was for these terms. There is also no evidence of [redacted] reinsuring the [redacted] contract.

We conclude that [redacted] was not an insurance company for income tax purposes during tax years [redacted]. Our conclusion is based on two reasons. First, while neither the Code nor the regulations define the terms "insurance" or "insurance contract," the United States Supreme Court has explained that for an arrangement to constitute insurance for federal income tax purposes both risk shifting and risk distribution must be present. Helvering v. LeGierse, 312 U.S. 531 (1941). Risk shifting occurs if a person facing the possibility of an economic loss resulting from the occurrence of an insurance risk transfers some or all of the financial consequences of the potential loss to the insurer. The effect of such a transfer is that a loss by the insured will not affect the insured because the loss is offset by the insurance payment. Risk distribution incorporates the "law of large numbers" to allow the insurer to reduce the possibility that a single costly claim will exceed the amount available to the insurer for the payment of such a claim. 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).

Since [redacted] has written only three income replacement contracts, one [redacted] contract, and one [redacted] contract, we conclude that there was no risk distribution. Any claim paid on one of these contracts would be made in significant part from premiums paid by the purchaser of such contract. The so-called insured's loss would not be offset by the insurance payment, but would actually be more akin to a refund of the premium paid. Thus, the so-called insured would in significant part be paying for its own risk.

Moreover, with regard to the [redacted] contract, we conclude that it cannot be insurance. Because [redacted] is the owner of both [redacted] and [redacted] (the entity that purchased the [redacted] contract), there clearly cannot be risk distribution.

[redacted] has not transferred the potential economic loss from the insurance risk, and, if a claim were made on the contract, would be paying for his own risks.

Second, even if we assume, *arguendo*, that the income replacement and cosmetic medicine contracts are insurance (i.e., there is sufficient risk shifting and risk distribution), [redacted] was not primarily and predominantly in the business of issuing insurance contracts. Therefore, [redacted] was not an insurance company. In Inter-American Life Ins. Co. v. Commissioner, 56 T.C. 497 (1971), aff'd per curiam, 469 F.2d 697 (9th Cir. 1972), the issue before the court was whether the taxpayer was an insurance company. In that case, the taxpayer's shareholders formed the taxpayer for the ostensible purpose of reinsuring life insurance risks. During the years in issue, taxpayer did not maintain an active sales force, and although it initially secured a small amount of reinsurance business, its predominant source of income was from investments. The court concluded that the taxpayer's primary and predominant source of income was from investments and not from the insuring of risks. Further, the taxpayer's primary and predominant efforts were not expended in pursuit of its insurance activities. Accordingly, since the taxpayer did not use its capital and efforts for the purpose of earning income from the issuance of insurance, the taxpayer was not taxable as an insurance company. See also Cardinal Life Ins. Co. v. United States, 300 F. Supp. 387 (N.D. Tex. 1969); Industrial Life Ins. Co. v. United States, 344 F. Supp. 870 (D.S.C. 1972), aff'd per curiam, 481 F.2d 609 (4th Cir. 1973), cert. denied, 414 U.S. 1143 (1974).

For [redacted], [redacted] Form 990 shows $[redacted] in program service revenue, and a net gain from the sale of assets other than inventory of $[redacted] sold, and reinsured only three income replacement contracts during tax year [redacted] After reinsurance, [redacted] potential liability for these three contracts was less than $[redacted] The balance sheet included in [redacted] Form 990 shows savings and temporary cash investments of $[redacted] investment securities of $[redacted] and land, buildings, and equipment of $[redacted] Consequently, we conclude tha[redacted] predominant source of income for [redacted] is from investments, and that [redacted] was a C corporation in [redacted] Thus, [redacted] was not an insurance company for federal tax purposes for tax year [redacted]

[redacted] Form 990, Return of Organization Exempt from Income Tax, shows only $[redacted] in program service revenue. While [redacted] had negative income from its investments, its balance sheet for [redacted] shows that its investment in securities more than tripled from $[redacted] at the beginning of the year to $[redacted] at the end of the year. There is no evidence that [redacted] wrote any new contracts in [redacted] and merely renewed the three income replacement contracts it had sold in [redacted]. Given these facts, we conclude that [redacted] did not use its capital and efforts for the purpose of earning income from the issuance of insurance in [redacted] As in [redacted] was a C corporation whose predominant activity was investing in [redacted] and was not an insurance company for federal tax purposes for tax year [redacted]

The file does not contain financial statements or tax returns for [redacted] tax year. The file does provide, though, that [redacted] sold only two contracts in [redacted]—and, as we explained above, the [redacted] contract cannot be deemed an insurance contract since there was no risk distribution. We conclude that [redacted] did not use its capital and efforts for the purpose of earning income from the issuance of insurance for [redacted] Thus, Apex was not an insurance company for federal tax purposes for tax year [redacted]

There is nothing in the file regarding any contracts [redacted] may have sold in [redacted] nor is there any evidence regarding [redacted] premium and investment income for [redacted] Accordingly, we cannot make any conclusions regarding tax year [redacted]

If you have any questions concerning this memorandum, please contact Sheryl Flum, CC:FIP:4, (202) 622-

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