Office of Chief Counsel
Internal Revenue Service
memorandum
CC:FIP:B04:JAPolfer

date:

to: Robert C. Harper, Jr.
Manager, EO Technical Group 3
T:EO:RA:T:3

from: Donald J. Drees, Jr.
Senior Technician Reviewer, Branch 4
(Financial Institutions & Products)

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subject: [redacted]
Technical Assistance Request
PRENO-116300-05

This memorandum responds to your request for technical assistance regarding the above company, dated March 23, 2005. You asked us to advise you 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, tha[redacted] does not qualify as an insurance company for federal income tax purposes for the tax year ending [redacted] There is insufficient information in the file to make any determination whether [redacted] qualifies as an insurance company after [redacted]

FACTS

[redacted] was incorporated in the state of [redacted] on [redacted] and is licensed as a captive insurance company domiciled in [redacted]

[redacted] percent of [redacted] stock is owned by [redacted], [redacted] percent is owned by [redacted], and [redacted] percent is owned by [redacted] (collectively referred to as "the Owners"). The Owners are mutual insurance companies and provide property and casualty insurance.

[redacted] states that its purpose is to provide property catastrophe reinsurance for the Owners. [redacted] intends to enter into a reinsurance arrangement for a $[redacted] excess of $[redacted] catastrophe coverage for business written by the Owners. [redacted] states that its formation is a means by which the Owners can obtain reinsurance coverage for their policies at an affordable price, will allow the Owners to efficiently fund for low frequency/high severity exposure, and will allow the Owners to "accumulate

surplus to provide future flexibility in protecting their underwriting results." [redacted] initial capital contribution totaled $[redacted] As of [redacted] has not entered into any insurance or reinsurance contracts and has received no premium income.

LAW AND ANALYSIS

Section 501(c)(15) recognizes insurance companies or associations other than life (including interinsurers and reciprocal underwriters) as exempt if the net written premiums (or, if greater, direct written premiums) for the taxable year do not exceed $350,000 for years prior to January 1, 2004. For taxable years beginning after December 31, 2003, the law has been amended stating gross receipts can total $600,000 and premium income must be at least 50% of total gross receipts.

Qualification as an insurance company must be satisfied annually. Section 1.801-3(a)(1) of the Income Tax Regulations; Indus. Life Ins. Co. v. United States, 344 F.Supp. 870, 877 (D.S.C. 1972) aff'd per curiam 481 F.2d 609 (4th Cir. 1973). Section 1.801-3(a)(1) defines the term "insurance company" to mean a company whose primary and predominant business activity during the taxable year is the issuing of insurance or annuity contracts or the reinsuring of risks underwritten by insurance companies. Section 831(c), which applies to taxable years beginning after December 31, 2003, provides that, for purposes of § 831, the term "insurance company" has the meaning given to such term by § 816(a). Under § 816(a), the term "insurance company" means any company more than half of the business of which during the taxable year is the issuing of insurance or annuity contracts or the reinsuring of risks underwritten by insurance companies.

While a taxpayer's name, charter powers, and state regulation help to indicate the activities in which it may properly engage, whether the taxpayer qualifies as an insurance company for tax purposes depends on its actual activities during the year. Inter-American Life Ins. Co. v. Commissioner, 56 T.C. 497, 506-08 (1971), aff'd per curiam, 469 F.2d 697 (9th Cir. 1972) (taxpayer whose predominant source of income was from investments did not qualify as an insurance company); see also Bowers v. Lawyers Mortgage Co., 285 U.S. 182, 188 (1932). To qualify as an insurance company, a taxpayer "must use its capital and efforts primarily in earning income from the issuance of contracts of insurance." Indus. Life Ins. Co. v. United States, 344 F. Supp. 870, 877 (D. S.C. 1972), aff'd per curiam, 481 F.2d 609 (4th Cir. 1973). All of the relevant facts will be considered, including but not limited to, the size and activities of any staff, whether the company engages in other trades or businesses, and its sources of income. See generally United States v. Home Title Ins. Co., 285 U.S. 191, 195 (1932) (where insurance and charges incident thereto were more than 75% of company's income, "[u]ndeniably insurance [was] its principal business."); Lawyers Mortgage Co. at 188-90; Indus. Life Ins. Co., at 875-77; Cardinal Life Ins. Co. v. United States, 300 F. Supp. 387, 391-92 (N.D. Tex. 1969), rev'd on other grounds, 425 F. 2d 1328 (5th Cir. 1970); Serv. Life Ins. Co. v. United States, 189 F. Supp. 282, 285-86 (D. Neb. 1960), aff'd on other grounds, 293 F.2d 72 (8th Cir. 1961); Inter-American Life Ins.

Co., at 506-08 ; Nat'l. Capital Ins. Co. of the Dist. of Columbia v. Commissioner, 28 B.T.A. 1079, 1085-86 (1933).

Cardinal Life Insurance Co. involved a company chartered to write life, health and accident coverage. During two of the five years at issue, Cardinal Life did not issue insurance contracts or reinsure risks underwritten by insurance companies; its premium income was $0 and it had no reserves. For the remaining three years, Cardinal Life reinsured risks underwritten by an insurance company; its premium income was less than 1% of its income for two of those years and approximately 9% in the third. Its reserves were minimal. Cardinal Life never employed any agents or brokers though it did retain an actuary; the reinsurance agreement was negotiated by its one stockholder. Meanwhile, Cardinal Life had income from dividends and interest, leasing real estate and trailers, and capital gains. The district court concluded that, for the two years Cardinal Life did not earn any income from the issuance of any insurance contracts, "as a matter of law, it was not a life insurance company during those years." Cardinal Life Ins. Co., at 392. The court held that Cardinal Life was not an insurance company for any of the years at issue because its capital and efforts were devoted primarily to its investment activity; it did not solicit insurance business and derived insignificant amounts of income from what insurance business it transacted while deriving substantial income from its investments.

Neither the Code nor the regulations define the term "insurance." The United States Supreme Court, however, has explained that in order for an arrangement to constitute insurance for federal income tax purposes, both risk shifting and risk distribution must be present. Helvering v. Le Gierse, 312 U.S. 531 (1941). Further, the Court states that "the risk must be an 'insurance risk' as opposed to an 'investment risk'..." Id. at 542. In Allied Fidelity Corp. v. Comm'r, 66 T.C. 1068, 1074 (1976), aff'd 572 F.2d 1190 (7th Cir. 1978), the Tax Court wrote that this risk is a risk of "a direct or indirect economic loss arising from a defined contingency," so that an "essential feature of insurance is the assumption of another's risk of economic loss."

Risk shifting occurs if a person facing the possibility of an economic loss transfers some or all of the financial consequences of the potential loss to the insurer, such that a loss by the insured does not affect the insured because the loss is offset by the insurance payment. Risk distribution incorporates the statistical phenomenon known as the law of large numbers. Distributing risk allows the insurer to reduce the possibility that a single costly claim will exceed the amount taken in as premiums and set-aside for the payment of such a claim. By assuming numerous relatively small, independent risks that occur randomly over time, the insurer smoothes out losses to match more closely its receipt of premiums. Clougherty Packing Co. v. Comm'r., 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. Comm'r., 881 F.2d 247, 257 (6th Cir. 1989).

As of [redacted] has not entered into any insurance or reinsurance contracts and has received no premium income. Because it received no

premium income during the tax year [redacted] "as a matter of law, it was not a life insurance company during [that year]." See Cardinal Life Ins. Co. There is insufficient information in the file to make any determination whether [redacted] qualifies as an insurance company after [redacted]

If you have any questions concerning this memorandum, please contact James Polfer, CC:FIP:4, (202) 622-3970.