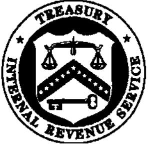

TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

Release Number: **200724036**
Release Date: 6/15/07
UIL: 501.15-00
Date: March 20, 2007

Contact Person:

Identification Number:

Contact Number:

FAX Number:

Employer Identification Number:

Legend:

Offshore =

Captive Insurance =

M =
G =
X =
Y =
Z =

Local Jail =
Local Coroner =
State =

Dear :

We have considered your application for recognition of exemption from Federal income tax under section 501(a) of the Internal Revenue Code. Based on the information provided, we have concluded that you do not qualify for exemption under section 501(c)(15). The basis for our conclusion is set forth below.

On January 9, 2004 Captive Insurance was incorporated under the laws of Offshore. Captive Insurance is wholly owned by M. M also serves as Captive Insurance's secretary and director. M's husband, G, is actively involved with Captive Insurance as President and Director. Captive Insurance has no other officers and directors.

G is the sole owner of two professional, medical corporations: X and Y. X employs Local Jail personnel, including G, two physicians and a nurse. G is also the coroner for Local Coroner where he is associated with four other doctors in the coroner's office.

Captive Insurance's business plan states that it was formed to provide G, and possibly M and other affiliated State physicians, a limited amount ($) of medical malpractice insurance. State medical malpractice law requires physicians to maintain $ of insurance as a prerequisite to be eligible to participate in State's patient compensation fund. The fund covers each member physician's medical malpractice liabilities that exceed $, and limits a patient's total per claim recovery to $ plus future medical costs. Prior to Captive Insurance's formation, G was eligible to participate in the State's fund in that he self-insured the first $ of his medical malpractice liability with a $ bank letter of credit.

In 2004, Captive Insurance issued three one-year "insurance contracts." The contracts were issued to G, M, and Local Coroner. G and M's contracts each provided $ per claim of medical malpractice coverage. G's $ premium represented % of Captive Insurance's 2004 gross premiums. M's $ premium represented % of Captive Insurance's 2004 gross premiums. Local Coroner's contract covered $ per claim of its risks relating to personal injury, property damage, advertising liability and managed care liability. Local Coroner's $ premium represented % of Captive Insurance's 2004 gross premiums.

In 2005, Captive Insurance issued six one-year "insurance contracts." Captive Insurance renewed its three outstanding contracts (G, M, and Local Coroner) and issued three additional contracts. The new contracts provided "insurance" for G's business office, flood insurance for G and M, and flood insurance for Z (an unidentified company). Premiums collected from each entity represented the following percentages of Captive Insurance's 2005 gross premiums: G's $ malpractice premium (%), M's $ premium (%), Local Coroner's $ (25.46%), G's business liability premium (%), G's and M's $ flood premium (%), and Z's $ flood premium (%).

On May 17, 2005 Captive Insurance made an election under section 953(d) of the Code to be treated as a domestic organization for federal income tax purposes. However, the effective date of Captive Insurance's election is unclear. Captive Insurance's election states it "is effective as of the first day of the electing corporation's taxable year (including a short taxable year) commencing." If Captive Insurance's election is invalid, its status as an insurance company for federal income tax purposes would be moot because Captive Insurance would not be subject to United States taxation.

Nonetheless, regardless of the section 953(d) of the Code election, Captive Insurance fails to qualify as an insurance company for federal income tax purposes.

Section 501(a) of the Code provides that organizations described in sections 501(c) or (d) shall be exempt from income tax unless such exemption is denied by sections 502 or 503. For tax years beginning on or after January 1, 2004, section 501(c)(15) described an insurance company or association other than life (including interinsurers and reciprocal underwriters) if (a) the gross receipts for the taxable year do not exceed $, and (b) more than 50 percent of such gross receipts for the taxable year consists of premiums.

Section 1.801-3(a)(1) of the Income Tax regulations 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. Qualification as an insurance company must be satisfied annually. Section 1.801-

3(a)(1); Indus. Life Ins. Co. v. United States, 344 F.Supp. 870, 77 (D.S.C. 1972), aff'd, 481 F.2d 609 (4th Cir. 1973). Section 831(c) of the Code defines a non-life insurance company by reference to section 816(a) of the Code, which defines an insurance company as any company more than half the business of which during the taxable year is the issuing of insurance or annuity contracts or the reinsuring of risks underwritten by insurance companies.

Neither the Code nor the regulations define the terms insurance or reinsurance. The United States Supreme Court, however, 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. Le Gierse, 312 U.S. 531 (1941). The risk transferred must be risk of economic loss. Allied Fidelity Corp. v. Commissioner, 572 F.2d 1190, 1193 (7th Cir.), cert. denied, 439 U.S. 835 (1978). The risk must contemplate the fortuitous occurrence of a stated contingency, Commissioner v. Treganowan, 183 F.2d 288, 290-91 (2d Cir. 1950), and must not be merely an investment or business risk. Le Gierse, 312 U.S. at 542; Rev. Rul. 89-96, 1989-2 C.B. 114). Cases analyzing "captive insurance" arrangements have distilled the concept of "insurance" for federal income tax purposes to three elements, applied consistently with principles of federal income taxation: 1) involvement of an insurance risk; 2) shifting and distribution of that risk; and 3) insurance in its commonly accepted sense. See AMERCO, Inc. v. Commissioner, 979 F.2d 162, 164-65 (9th Cir. 1992), aff'g 96 T.C. 18 (1991).

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). See also Kidde Indus. Inc. v. United States, 40 Fed. Cl. 42, 58 (1997).

Several courts have recognized that risk distribution necessarily entails a pooling of premiums, so that a potential insured is not in significant part paying for its own risks. The courts have held that, when a company "insures" unrelated risks, the arrangement constitutes insurance if a significant percentage of unrelated risks exists. Ocean Drilling & Exploration Co. v. United States, 988 F.2d 1135, 52-53 (Fed. Cir. 1993) (sufficient distribution existed where parent related premiums were pooled with premiums derived from % unrelated risks during the two years at issue); Sears, Roebuck & Co. 96 T.C. 61, 100-02 (sufficient distribution existed where parent related premiums were pooled with premiums from % unrelated risks; the % premiums derived from parent represented % of the subsidiary insurance company's risk); Harper Group v. Comm'r, 96 T.C. 45, 58 (1991) (adequate distribution where parent related premiums were pooled with premiums from % unrelated risks).

Although courts have not yet established a bright line percentage test, Harper Group represents the edge of the spectrum as the Tax Court found an insurance agreement with the least amount of unrelated risk (%). The transaction, in Harper Group, involved cargo insurance for a cargo company with more than , unrelated customers. The court highlighted "the relatively large number of unrelated insureds" as a basis for finding significant risk distribution. , at 59. Likewise, other cases recognize that risk distribution involves not only the portion of

unrelated risks assumed but also a large number of insureds. See, e.g., Humana, 881 F.2d 24 (during the years at issue the taxpayer operated an average of hospitals with patient beds). HCA v. Comm'r, T.C. Memo 1997-482 (1997) (taxpayer operated an average of 160 hospitals with an average of patient beds).

Based upon the longstanding risk distribution and risk shifting authorities mentioned above, the Service published Rev. Rul. 2002-90 and Rev. Rul. 2005-40.

Rev. Rul. 2002-90 concludes that an arrangement qualifies as insurance for federal income tax purposes where a subsidiary provides coverage of the insurance risks of sibling corporations, each of which present a significant volume of independent, homogeneous risks and none of which account for less than % or more than % of the subsidiary's assumed risk with no parental (or other related party) guarantees of performance.

Unlike the fact pattern described in the Rev. Rul. 2002-90, Captive Insurance offers coverage to only three entities in 2004, not . In 2005, Captive Insurance still maintained too few risks with only six "insureds." These insured risks were not homogenous, which further diluted the distribution within the small number of insureds.

Rev. Rul. 2005-40, 2005-27 I.R.B. 4 (July 5, 2005), concludes that where the total risks assumed can be allocated % to one entity and % to another, risk distribution has not been achieved and the arrangements shifting the risk do not constitute insurance.

Like the situations described in Rev. Rul. 2005-40, too much risk was concentrated in one party, G (% in 2004 and % in 2005). Unlike Harper Group, Captive Insurance's number of insured risks remained relatively low (only five risk exposure units in 2004 and seven in 2005). As such, adequate risk distribution was not present as Captive Insurance combined too few insureds with too few risks insureds.

Furthermore, Captive Insurance's risks were spread over too many different lines of high-risk coverage. 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., 811 F.2d at 1300. In 2004, Captive Insurance's total premium pool was $ however, Local Coroner's contract exposed the pool to a contingent $ per occurrence liability. In 2005, Captive Insurance's additional business caused Captive Insurance to take on significantly greater potential liabilities with total 2005 risks equaling was $ Captive Insurance's Form 1024 indicated its 2004 capital as $. No information was provided regarding any additions to Captive Insurance's capital in 2005, other than its premium income, which was merely $ If a single event of maximum exposure occurred under Local Coroner's policy or one of the additional 2005 business' policies, Captive Insurance would not be financially able to sustain the loss. Risk distribution seeks to avoid this exact situation by incorporating 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., 811 F.2d at 1300.

Finally, Captive Insurance did not achieve the requisite risk shifting in 2004 as G's $ premium exceeded the $ per claim coverage he obtained. Clougherty Packing Co., 811 F.2d at 1300; Ocean Drilling & Exploration Co., 988 F.2d at 1151.

Captive Insurance's contract with G, which represented more than % of its 2004 business, did not shift G's risk to Captive Insurance in 2004. Moreover, Captive Insurance's contracts did not adequately distribute risk in 2004 or 2005. Therefore, Captive Insurance is not an insurance company in either 2004 or 2005 because more than % of its business in either year did not consist of issuing contracts that qualified as insurance contracts for federal income tax purposes.

Accordingly, you do not qualify for exemption as an organization described in section 501(c)(15) of the Code and you must file federal income tax returns.

You have the right to file a protest if you believe this determination is incorrect. To protest, you must submit a statement of your views and fully explain your reasoning. You must submit the statement, signed by one of your officers, within 30 days from the date of this letter. We will consider your statement and decide if the information affects our determination.

Your protest statement should be accompanied by the following declaration:

> *Under penalties of perjury, I declare that I have examined this protest statement, including accompanying documents, and, to the best of my knowledge and belief, the statement contains all the relevant facts, and such facts are true, correct, and complete.*

You also have a right to request a conference to discuss your protest. This request should be made when you file your protest statement. An attorney, certified public accountant, or an individual enrolled to practice before the Internal Revenue Service may represent you. If you want representation during the conference procedures, you must file a proper power of attorney, Form 2848, *Power of Attorney and Declaration of Representative,* if you have not already done so. For more information about representation, see Publication 947, *Practice before the IRS and Power of Attorney.* All forms and publications mentioned in this letter can be found at www.irs.gov, Forms and Publications.

If you do not intend to protest this determination, you do not need to take any further action. If we do not hear from you within 30 days, we will issue a final adverse determination letter. That letter will provide information about filing tax returns and other matters.

Please send your protest statement, Form 2848 and any supporting documents to this address:

Internal Revenue Service
TE/GE (SE:T:EO:RA:T3)

1111 Constitution Ave, N.W.
Washington, DC 20224

You may also fax your statement using the fax number shown in the heading of this letter. If you fax your statement, please call the person identified in the heading of this letter to confirm that he or she received your fax.

If you have any questions, please contact the person whose name and telephone number are shown in the heading of this letter.

Sincerely,

Lois G. Lerner
Director, Exempt Organizations
Rulings & Agreements

TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

Date: March 20, 2007

Contact Person:

Identification Number:

Contact Number:

Employer Identification Number:

Form Required To Be Filed:

Tax Years:

Dear Applicant:

This is our final determination that you do not qualify for exemption from Federal income tax under Internal Revenue Code section 501(a) as an organization described in Code section 501(c)(15). Recently, we sent you a letter in response to your application that proposed an adverse determination. The letter explained the facts, law and rationale and gave you 30 days to file a protest. Since we did not receive a protest within the requisite 30 days, the proposed adverse determination is now final.

You must file Federal income tax returns on the form and for the years listed above within 30 days of this letter, unless you request an extension of time to file. File the returns in accordance with their instructions, and do not send them to this office. Failure to file the returns timely may result in a penalty.

We will make this letter and our proposed adverse determination letter available for public inspection under Code section 6110, after deleting certain identifying information. Please read the enclosed Notice 437, *Notice of Intention to Disclose,* and review the two attached letters that show our proposed deletions. If you disagree with our proposed deletions, follow the instructions in Notice 437. If you agree with our deletions, you do not need to take any further action.

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. If you have any questions about your Federal income tax status and responsibilities, please contact IRS Customer Service at

1-800-829-1040 or the IRS Customer Service number for businesses, 1-800-829-4933. The IRS Customer Service number for people with hearing impairments is 1-800-829-4059.

Sincerely,

Robert Choi
Director, Exempt Organizations
Rulings & Agreements

Enclosure
Notice 437
Redacted Proposed Adverse Determination Letter
Redacted Final Adverse Determination Letter