DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
1100 Commerce
Dallas, Texas 75242

UIL: 501.15-00

Number: **200736033**
Release Date: 9/7/2007

May 24, 2007

ORG

CERTIFIED MAIL – RETURN RECEIPT REQUESTED

Dear :

This is our final adverse determination letter as to your exempt status under I.R.C. § 501(c)(15) of the Internal Revenue Code. Our adverse determination was made because, for the year(s) of the examination, you were not operated as an "insurance company" within the meaning of I.R.C. § 501(c)(15) of the Internal Revenue Code. Your exempt status is revoked effective December 5, 20XX.

We have also enclosed Publication 892, Exempt Organization Appeal Procedures for Unagreed Issues, and Publication 3498, *The Examination Process*. These publications include information on your rights as a taxpayer. They explain appeal rights and the procedure for obtaining technical advice.

Because this case involves exemption under I.R.C. § 501(c)(15), you cannot contest the adverse determination in a declaratory judgment action under I.R.C. § 7428. You can, however, contest the revocation of exempt status in the context of any related deficiency case involving adjustments that flow from the loss of exemption. Thus, you may file suit in United States Tax Court, the United States Court of Federal Claims, or United States District Court, from any deficiency notice issued in this case or a related case after satisfying procedural and jurisdictional requirements as described in Publications 3498 and 892.

You are required to file federal income tax returns for the tax period(s) shown above, for all years still open under the statute of limitations, and for all later years. File the federal tax return for the tax period(s) shown above with the Ogden Service Center within 60 days from the date of this letter, unless a request for an extension of time is granted. File returns for later tax years with the appropriate service center indicated in the instructions for those returns.

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, however, 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:

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,

Marsha A. Ramirez
Director, EO Examinations

Enclosures:
Publication 892
Publication 3498

cc:

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
1100 Commerce
Dallas, Texas 75242

ORG

CERTIFIED MAIL – RETURN RECEIPT REQUESTED

Dear :

We have enclosed a copy of our report of examination explaining why we believe an adjustment of your organization's exempt status is necessary. In addition, under separate cover, we will also be sending you a final adverse determination letter revoking your exempt status. If you have any questions, please call the contact person at the telephone number shown in the heading of this letter.

Thank you for your cooperation.

Sincerely,

Marsha A. Ramirez
Director, EO Examinations

Enclosures:
Report of Examination

cc:

LEGEND:

ORG = Name of Company   EIN = Num   Subsidiary = Name of sub
FC = Foreign Country   Officer - President ABC Co - Name Liab Compy
Related - Lastname & Name of C Corp   CPA - Name of Rep
FCity = Foreign City   Def, Inc. = Sub to Related Enterprise
JKL Insurance Agency = Name of Outside Ins Company

ISSUE: Whether ORG is an insurance company exempt from income tax pursuant to I.R.C. § 501(c)(15) for the taxable year 20XX.

FACTS:

ORG was incorporated under the laws of the FC pursuant to a Memorandum of Association dated July 26, 20WW. The Memorandum of Association is stamped as being registered and filed on July 27, 20WW with the Assistant Registrar of Companies, FC. Item 3 of the Memorandum of Association sets forth a list of "objects for which the Company is established …," including "[t]o do or carry on any … business which the company may from time to time determine."

On October 30, 20WW, ORG submitted to the Internal Revenue Service (the "Service") Form 1024, Application for Recognition of Exemption under Section 501(a). The Form 1024 was signed by an officer of the organization and it requested tax-exemption under I.R.C. § 501(c)(15). The Form 1024 required consideration by the Service's National Office in Washington D.C., which has jurisdiction over this section of the Internal Revenue Code. Accordingly, the application was transferred to the National Office for review.

ORG application, Form 1024 at Part II, Activities and Operational Information, states as follows:

> "ORG is being organized to participate in the insurance business as permitted by IRC Section 501(c)(15). Specifically, ORG intends to write insurance policies for property and casualty risk. Industries expected to be served are service stations, convenience stores and private aircraft operator associations."
>
> "The business activities of ORG will commence upon IRS approval of this application and after obtaining necessary insurance licenses from the FC government."

> "This activity will be conducted in the United States, principally by Mr. Officer."

Also noted on the Form 1024, at Part III, Financial Data, as of December 31, 20XX, ORG anticipated having a gain on the sale of assets in the amount of $3,000,000 and investment income in the amount of $150,000. In addition, ORG indicated on Schedule I of Form 1024 that it was a member of a controlled group of corporations as defined in I.R.C. § 831(b)(2)(B)(ii). However, ORG Form 1024 does not indicate that it intended to create a wholly owned subsidiary to conduct the insurance business for which it was seeking exemption under section 501(c)(15).

During the Service's examination of ORG Form 1024, on March 27, 20XX, ORG faxed to the examiner what purported to be an election under I.R.C. § 953(d) to be treated as a domestic corporation for United States tax purposes with an effective date of August 8, 20WW. The Service's records, however, do not show that this election was approved or that it was actually filed.

In a letter, dated April 24, 20XX, the Service determined that ORG was an exempt organization described in section 501(c)(15). This determination was expressly "[b]ased on the information supplied, and assuming your operation will be as stated in your application for recognition of exemption … ." This letter also advises the organization to "notify the Ohio Tax Exempt and Government Entities (TE/GE) Customer Service office if there is any change in its name, address, sources of support, purposes or method of operation."

Contrary to the representations made in its Form 1024, ORG did not commence doing business as an insurance company upon the Service's approval of the application. In fact, there is no evidence that ORG ever directly engaged in any insurance activities. Instead, on December 5, 20XX, ORG formed a wholly owned subsidiary, Subsidiary ("Subsidiary Group"), to engage in the insurance business and ORG treated this separate corporation as a d/b/a on its Forms 990 for the years 20XX and 20YY.

When requested for a business plan by the Service's examiner in the current examination, ORG provided the examiner with the Subsidiary Group's Business Plan. This document provides the following:

"Subsidiary is being incorporated as what is known in the United States as a Closely-Held Insurance Company (CHIC) to take advantage of the favorable tax treatment afforded to insurance companies under Section 501(c)(15) of the Internal Revenue Code.

Essentially, so long as the company is: (1) primarily in the business of insurance; and (2) receives less than $350,000 in annual insurance premiums, the company is tax exempt, subject to certain restrictions. This means that the insurance company may obtain the following tax benefits:

Premium Income Received Is Not Taxed.

All insurance premiums are received by the company tax-free.

Passive Investment Income Received Is Not Taxed.

This is the really **(<u>sic</u>)** the main benefit of qualifying as a 501(c)(15) insurance company. So long as the company continues to qualify under the Internal Revenue Code, its passive investment income is not taxed. What this means for qualifying insurance companies, under certain circumstances is that:

Capital Gains are not taxed.

This means that if a person has a large appreciated asset, whether a large bloc of IPO stock or appreciated real estate, that they could transfer those assets to the insurance company as reserves and surplus, and the insurance company could liquidate and diversify those assets with NO tax immediately payable. Further, short-term capital gains, dividends earned by stock held by the company, etc. as reserves and surplus, are not taxed.

Royalty Income is not taxed.

Royalty streams, such as income streams from patents, copyrights, and trademarks which have been contributed to the insurance company as reserves and surplus, are not taxed.

Taxes are Deferred.

Although the 501(c)(15) insurance company typically pays no taxes, the owner of the company will pay taxes: (1) whenever a distribution is made or a salary or management fee paid, at ordinary income tax rates; and (2) when the insurance company is sold or liquidated long-term capital gains rates will be paid (assuming the insurance company has been held for a significant amount of time. **(sic)** This allows the owner of a 501(c)(15) insurance company to convert ordinary income (premiums received) and non-long term capital gains investment income, into long-term capital gains which are deferred until the company is sold."

In December 20XX, Subsidiary entered into a Quota Share Retrocession Agreement (the "Retrocession Agreement") with ABC Co Liability SP ("ABC Co"). Under this agreement, the Subsidiary is referred to as the "Retrocessionaire" and ABC Co is referred to as the "Company." Article 1, item 1., of the Retrocession Agreement provides, in part,

"It is hereby agreed that the Company shall pay to the Retrocessionaire fifty percent (50%) of all premiums received by the Company under the aforesaid Underlying Agreement, and that the Retrocessionaire shall pay to the Company fifty percent (50%) of all losses and loss adjustment expenses payable by the Company under the said Underlying Agreement, and shall reimburse the Company for fifty percent (50%) of all commission, brokerage and other costs whatsoever payable by the company under the said Underlying Agreement, whenever payment is made or received by the Company under the said Underlying Agreement."

The Retrocession Agreement at Article V provides that

"The Company hereby agrees that it will limit the liability to the Retrocessionaire to an annual aggregate amount of the total net premiums ceded plus T$300,000. The Retrocessionaire agrees to pay the Company 5% of ceded premiums to provide this aggregate cover."

ORG Form 990 for the calendar year ending 20XX, which treats the Subsidiary as a d/b/a, reflects that its reported revenue was derived from two distinct sources:

1. Program service revenue representing reinsurance premiums in the amount of $52,938. All of this revenue was actually earned by the Subsidiary under the Retrocession Agreement. This income represents 16.22% of ORG total reported income for the year.

2. Dividends and interest from securities in the amount of $273,405. This investment income represents 83.78% of ORG total reported income for the year.

From February 20XX to June 20XX, ORG entered into five unsecured promissory notes with Officer of Related Enterprises, Inc. The total amount of these unsecured loans was $6,000,000. Each of these loans provide that interest is to be paid annually on February 15 of each year, with the principal due February 15, 2007.

ORG Form 1024 identifies an Officer as its President. Moreover, according to ORG representative in his letter dated January 13, 20ZZ, responding to Information Document Request #1, "[t]he owners of 100% of the voting stock of Related Enterprises, Inc. also own 100% of the stock of ORG Company, Ltd." ORG ownership structure is as follows:

Subsidiary	Related (father)	20%
	Related (son)	20%
	Related (son)	20%
	(daughter)	20%
	(daughter)	20%

In response to each Information Document Request ("I.D.R.") issued by the Service during the current examination of ORG, ORG representative, CPA, asserted that Subsidiary is a d/b/a of ORG and treated the two corporations as if they were one and the same. This fact is most evident in his September 23, 20ZZ letter responding to I.D.R. #2, asking about ORG insurance activities during 20XX. That letter includes the following preamble:

> "Before addressing your specific questions, I think it would be helpful to point out that the insurance activities of the taxpayer in 20XX were just beginning. It entered into a Quota Share Retrocession Agreement ("Retrocession Agreement") with ABC Co Liability SP ("ABC Co "). The terms of this Retrocession Agreement provided that the taxpayer, in exchange for receiving ceded premium from ABC Co, agreed to be liable for certain losses above and within certain limits. The Retrocession Agreement is enclosed and speaks for itself. This was the manner in which the taxpayer expected to participate in the insurance business (as was described in the taxpayer's application for tax exempt status - also enclosed). The taxpayer did not write direct insurance policies to consumers; rather it acted in essence as a reinsurer of a large pool of risks."

In addition, in response to requests 1, 3 and 4 of I.D.R. #2, ORG representative stated the following:

> "1. The maximum exposure to ORG Company under the Retrocession Agreement was equal to the amount of net ceded premiums plus T$300,000."
>
> ...
>
> 3. It is my understanding that FC law imposes that minimum capital of US$120,000 be maintained in cash. The taxpayer has at all times met that requirement. Total capital as of December 31, 20XX was approximately $6.4 million. This is substantially similar to the pro-forma financial statements included in the taxpayer's application for tax-exempt status.
>
> 4. Because of the nature of the taxpayer's insurance activities (described above) it does not receive or process claim reports. It is the taxpayer's understanding that ABC Co receives and processes

claims and makes loss payments as and when appropriate. The only information that the taxpayer has received regarding claims made and loss payments are contained in ceding statement received from ABC Co. I have attached a ceding statements dated December 31, 20XX that was provided to the taxpayer on July 18, 20YY by ABC Co.

ORG representative, in an attachment to his letter of January 13, 20ZZ, provided a copy of a formal audit done of the Subsidiary Group. This audit was performed by Moore Stephens (FC) Ltd. Notes 1, 4 and 10 to the financial statements provide as follows:

1. "Subsidiary (the "Company") was incorporated under the laws of the FC on December 5, 20XX, and is licensed as an Unrestricted Class "B" Insurer under the FC Insurance Law 1979. It is wholly owned by ORG (the Parent).

The Company assumed a quota share retrocession agreement written by ABC Co Liability Segregated Portfolio covering a portion of the risks of JKL Insurance Agency which writes business, home and vehicle policies in FCity. Under the terms of the retrocession agreement, the Company obligates itself to accept 50% of ABC Co 's obligation, liabilities and premiums written. The effective date of this agreement was December 16, 20XX."

4. "ORG holds 100% of the shares of the Company and is therefore a Officer party. DEF, Inc. is wholly owned by Related Enterprises, Inc. and is Officer to the Company through one of its Directors."

10. "The Company has not elected to be treated as a US taxpayer. Accordingly, income taxes, if any, are payable by the Parent."

LAW:

I.R.C. § 501(a) provides, "[a]n organization described in subsection (c) or (d) or section 401(a) shall be exempt from taxation under this subtitle unless such exemption is denied under section 502 or 503."

I.R.C. § 501(c)(15)(A) provides, "[i]nsurance companies or associations other than life (including interinsurers and reciprocal underwriters) if the net written premiums (or, if greater, direct written premiums) for the taxable year do not exceed $350,000."

Treasury Regulation § 1.801-3(a)(1) provides, "[t]he 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. Thus, though its name, charter powers, and subjection to State insurance laws are significant in determining the business which a company is authorized and intends to carry on, it is the character of the business actually done in the taxable year which determines whether a company is taxable as an insurance company under the Internal Revenue Code."

Treasury Regulation § 1.6033-2(i) states that an organization which is exempt from taxation under section 501(a) and is not required to file annually shall immediately notify the Service in writing of any changes in its character, operations, or purpose for which it was originally created. This section further states that every organization exempt from tax whether or not it is required to file an annual information return, shall submit such additional information as may be required by the Internal Revenue Service for the purpose of inquiring into its exempt status and administering the provisions of the tax laws.

Procedural Regulation § 601.201(l)(5) provides, in part, that except in rare and unusual circumstances, the revocation or modification of a ruling will not be applied retroactively with respect to the taxpayer to whom the ruling was originally issued or to a taxpayer whose tax liability directly was involved in such ruling if (i) there has been no misstatement or omission of material facts, (ii) the facts subsequently developed are not materially different from the facts on which the ruling was based, (iii) there has been no change in the applicable law, (iv) the ruling was originally issued with respect to a prospective or proposed transaction, and (v) the taxpayer directly involved in the ruling acted in good faith in reliance upon the ruling and the retroactive revocation would be to his detriment.

Procedural Regulation § 601.201(n)(3)(ii) provides that "[a] ruling or determination letter recognizing exemption may not be relied upon if there is a material change inconsistent with exemption in the character, the purpose, or the method of operation of the organization."

Revenue Procedure 96-4, 1996-1 I.R.B. 94, provides, in relevant part, that except in rare and unusual circumstances, the revocation or modification of a ruling will not be applied retroactively with respect to the taxpayer to whom the ruling was originally issued or to a taxpayer whose tax liability directly was involved in such ruling provided that (i) there has been no misstatement or omission of material facts, (ii) the facts subsequently developed are not materially different from the facts on which the ruling was based, (iii) there has been no change in the applicable law, (iv) the ruling was originally issued for a proposed transaction, and (v) the taxpayer directly involved in the ruling acted in good faith in reliance upon the ruling and the retroactive revocation would be to his detriment.

Revenue Procedure 2004-1, 2004-1 I.R.B. 1, provides, in relevant part, that the revocation or modification of a letter ruling will be applied retroactively to the taxpayer for whom the letter ruling was issued if (i) there has been a misstatement or omission of controlling facts, or (ii) the facts at the time of the transaction at issue are materially different from the controlling facts on which the letter ruling is based.

Revenue Procedure 90-27, 1990-1 C.B. 514, provides, in part, that exempt status will be recognized in advance of operations if proposed operations can be described in sufficient detail to permit a conclusion that the organization will clearly meet the particular requirements of the section under which exemption is claimed. A mere statement of purposes or a statement that proposed activities will be in furtherance of such purposes will not satisfy this requirement. The organization must fully describe the activities in which it expects to engage, including the standards, criteria, procedures, or other means adopted or planned, and the nature of the contemplated expenditures. Where the organization cannot demonstrate to the satisfaction of the Service that its proposed activities will be exempt, a record of actual operations may be required before a ruling or determination letter will be issued.

Revenue Procedure 90-27 also holds that "revocation or modification [of an exempt organization that received a favorable determination letter] may be retroactive if the organization … operated in a manner materially different from that originally represented … . Where there is a material change, inconsistent with exemption, in the character, the purpose, or the method of operation of an organization, revocation or modification will ordinarily take effect as of the date of such material change."

Revenue Ruling 83-172, 1983-2 C.B. 106, holds that a group that has been created for the purpose of providing self-insured workmen's compensation under state law is taxable as an insurance company under the provisions of I.R.C. § 831, even though it is not recognized as an insurance company under state law.

Revenue Ruling 89-96, 1989-2 C.B. 114, holds that the assumption of investment risk cannot create an insurance agreement for federal income tax purposes.

Revenue Ruling 92-93, I.R.B. 1992-45, holds that, where a parent corporation purchased group-term life insurance on its employees from its wholly owned insurance subsidiary, the arrangement was not "self-insurance" because the economic risk of loss being insured was not that of the parent.

Revenue Ruling 20WW-31, 20WW-1 C.B. 1348, states that the Internal Revenue Service (the "Service") will no longer invoke the "economic family theory" set forth in prior Revenue Rulings in addressing whether captive insurance transactions constituted valid insurance. Rather, the Service will address captive insurance transactions on a case-by-case basis.

<u>Helvering v. LeGierse</u>, 312 U.S. 531 (1941), the seminal case on the definition of "insurance" for federal income tax purposes, the Supreme Court held that insurance involves risk shifting and risk

distributing. An individual purchased "life insurance" and "annuity" contracts from an insurance company. The individual's sole objective was to reduce estate taxes; the insurance company was not at risk of losing any more funds than it received, except perhaps through its own bad investments with those funds. The Supreme Court held that the proceeds from the contracts were not insurance proceeds because the contracts viewed together did not transfer an insurance risk. Thus, LeGierse held that two elements are consistently present when defining insurance (i.e.; risk shifting and risk distribution) and that these two elements are necessary when defining insurance for federal income tax purposes.

AMERCO, Inc. v. Commissioner, 979 F.2d 162 (9th Cir. 1992), the Ninth Circuit quoted with approval the Tax Court's identification of three principles at the heart of the LeGierse definition of insurance: (1) that an insurance transaction must involve "insurance risk," (2) that insurance involves risk shifting and risk distributing; and (3) that, in the absence of a statutory definition, "insurance" is to be defined in its commonly accepted sense.

Humana v. Commissioner, 881 F.2d 247 (6th Cir. 1989), held that payments made by a parent to its captive insurance subsidiary to insure its own potential liabilities are not deductible as insurance because the arrangement between the parent and the subsidiary did not accomplish real risk-shifting, while payments made by the parent to its captive insurance subsidiary to insure the potential liabilities of the parent's other subsidiaries were deductible as insurance since the subsidiaries' risk was being shifted to the insurer and then distributed among the various subsidiaries.

Clougherty Packing Co. v. Commissioner, 811 F.2d 1297 (9th Cir. 1987), involved a wholly-owned subsidiary incorporated in Colorado under state captive insurance laws. The parent company, Clougherty Packing Company ("Clougherty"), purchased insurance from an unOfficer insurer which then reinsured the first $100,000.00 of each claim against Clougherty with the subsidiary insurer. The subsidiary insurer's only business was reinsurance of the parent company's risk. The Ninth Circuit in Clougherty defined "insurance" as involving risk shifting and risk distributing. The court stated that "[i]f the insured has shifted its risk to the insurer, then a loss by or a claim against the insured does not affect it because the loss is offset by the proceeds of an insurance payment." Clougherty, 811

F.2d at 1300. With respect to risk distributing, the court stated that "[i]nsuring many independent risks in return for numerous premiums serves to distribute risk." Id. The court determined that there had been no shifting of the risk from the parent to the captive. As a matter of economic reality, every dollar paid out by the captive was a dollar out of the parent's pocket from whence it came. In fact, the arrangement was little different from a reserve fund held by the parent itself; only corporate formalities distinguished it. The court held that those formalities were not enough for insurance.

Allied Fidelity Corp. v. Commissioner, 572 F.2d 1190, 1193 (7th Cir.), cert. Denied, 439 US. 835 (1978), in distinguishing between bail bond contracts and insurance, the Seventh Circuit stated as follows:

> "[T]he 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 performance but stands ready to assume the financial burden of any covered loss. 1 Couch on Insurance 2d 1:2 (1959). As the tax court below noted, an insurance contract contemplates a specified insurable hazard or risk with one party willing, in exchange for the payment of premiums, to agree to sustain economic loss resulting from the occurrence of the risk specified and, another party with an 'insurable interest' in the insurable risk. It is important here to note that one of the essential features of insurance is this assumption of another's risk of economic loss. 1 Couch on Insurance 2d 1:3 (1959)."

Epmeier v. United States, 199 F.2d 508, 509-10 (7th Cir. 1952), the term "insurance contract" was defined as "a contract, whereby, for an adequate consideration, one party undertakes to indemnify another against loss from certain specified contingencies or perils. Fundamentally and shortly, it is contractual security against possible anticipated loss. Risk is essential and, equally so, a shifting of its incidence from one to another."

Commissioner v. Treganowan, 183 F.2d 288, 291 (2nd Cir.), cert. denied, 340 U.S. 853 (1950), the Second Circuit held that amounts received from the New York Stock Exchange Gratuity Fund by the widow of a deceased member of the Exchange were "proceeds of life insurance" for federal estate tax purposes. The Second Circuit stated as follows:

> "Here the risk of loss from premature death is effectively shifted from the individual to the group of other members of the Exchange. If the individual dies prematurely, the amount paid to his kin will exceed the amount of assessments which he himself has paid in, the difference representing the loss caused by the premature death which the group has had to bear. Had he not been a member of the plan, he would have saved the amount of the assessments against him before his death, but his beneficiaries would be $20,000 poorer. Thus, they would have borne this loss which, through the Exchange plan, he shifted to the group. And manifestly this plan provides a distribution of the risk, for because of the plan the risk of premature death is borne by the 1373 other members of the Exchange, rather than by the individual."

Bowers v. Lawyers Mortgage Co., 285 U.S. 182 (1932), the Supreme Court concluded the taxpayer was not an insurance company based on the character of the business actually done. The taxpayer was chartered as "Lawyers Mortgage Insurance Co." to examine titles and to guarantee or insure bonds and mortgages. Later, the company dropped "insurance" from its name and amended its charter to allow the purchase and sale of mortgage loans. It remained under the supervision of the state insurance department. However, Lawyers Mortgage never insured titles. Rather, it made mortgage loans which it sold with a guarantee of payment. For this "insurance," Lawyers Mortgage charged a so-called "premium" of one-half of one percent of the interest stated on the mortgage. The company also guaranteed the payment of some loans which it did not make or sell. Under state law, companies chartered as banks were also authorized to conduct this type of business. The Supreme Court concluded that though the guarantees were in legal effect insurance, this element of Lawyers Mortgage's activities was only incidental to the mortgage business; the "premium" covered non-insurance services. And the "premiums" were only one-third of Lawyers Mortgage's income. Accordingly, the character of the business actually done was not insurance and, therefore, the company was not an insurance company.

Industrial Life Insurance 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), the court held that the taxpayer was not an insurance company for federal income tax purposes because it was not using its capital and efforts primarily to earn income from insurance. Industrial Life was chartered as an insurance company but did not maintain a sales staff. Its office was located in the home of its president. During the three years at issue, the company's insurance activity consisted of covering small credit risks under a group policy issued to a consumer lender, covering the lives of certain of its officers (the company paid the premiums and was the beneficiary), and covering the lives of members of the stockholding family. The company also engaged in leasing and selling real estate and managing its investment portfolio. Industrial Life's premium income from insurance issued to parties unOfficer to its owners/officers (i.e.; the group credit risk policy) accounted for approximately 8% of its income during the years at issue. The company accumulated substantial earnings without showing a reasonable need. The district court concluded that Industrial Life was not an insurance company during the years at issue. Although it was involved in direct underwriting, it issued only one policy and its premium income was small compared with its income from its real estate activity.

Inter-American Life Insurance Co. v. Commissioner, 56 T.C. 497, 506-08 (1971), aff'd per curiam, 469 F.2d 697 (9th Cir. 1972), the Tax Court held that the taxpayer did not qualify as an insurance company due to its minimal volume of insurance business. Two individuals formed Investment Life Insurance Company to directly underwrite coverage which could be ceded to Inter-American. Although Inter-American was authorized to use several policy forms, it did not solicit or sell any directly written coverage during the years at issue. Rather, it accepted a small amount of business ceded to it by Investment Life and an unOfficer insurer. Inter-American also held the family's lumber business. Because of its minimal insurance activity, the state insurance commissioner became concerned about its continued participation in the insurance market. As a result, rather than surrender its certificate of authority to write insurance, Inter-American retroceded a major portion of its coverage to an unOfficer company. Meanwhile, Inter-American realized income from various capital assets. Although Inter-American had as many as 448 policies in force during the five years at issue with an aggregate coverage of $1.4 million, premiums accounted for 5% or less of Inter-American's income during four of the five years. The court concluded that Inter-American was not an insurance company for any of the years at issue because it did not use its efforts in the insurance business. It did not actively solicit to issue coverage. Its directly underwritten coverage was issued to the owner's family or their tax advisor and its reinsurance was from the Officer company, Investment Life. Its investment income far exceeded its de minimis earned premiums.

Cardinal Life Insurance Co. v. United States, 300 F. Supp. 387, (N.D. Tex. 1969), rev'd on other grounds, 425 F.2d 1328 (1970), 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 Cardinal Life was not an insurance company 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.

Service Life Insurance Co. v. United States, 189 F. Supp. 282 (D. Neb. 1960), aff'd on other grounds, 293 F.2d 72 (8th Cir. 1961), the court held that the taxpayer was an insurance company. During the years at issue, Service Life issued life, health and accident policies, and also solicited and arranged mortgage loans with money borrowed from the Federal Home Loan Bank. Between 35,000 and 70,000 policies were in force during the years at issue, representing life coverage of over $22,000,000. At the same time, only about 1,800 mortgages were outstanding. Service Life's premium income accounted for between 57% and 79% of its total income. Under these facts, the character of the business actually done by Service Life during the years at issue was insurance; hence it was an insurance company.

The Synanon Church v. Commissioner, T.C. Memo. 1989-270, the court stated, "There is no similar policy supporting the exemption from tax of an organization which obtains donations by misrepresenting itself to be engaged exclusively in charitable activities when, in fact, it is engaged in profit-seeking business activities. … If the character, purpose, activities or method of operation of the organization itself changes from those on which the ruling was based, the organization ceases as a matter of law to qualify as a tax-exempt organization. Its exemption, as in this case, may be revoked retroactively."

GOVERNMENT'S POSITION:

For the taxable year 20XX, ORG ("ORG") was not an insurance company exempt from tax pursuant to I.R.C. § 501(c)(15). ORG primary and predominant business activity during the year was engaging in security and investment buying and trading, and not the business of insurance. In fact, ORG did not directly engage in any insurance business during the year 20XX but, instead, created a subsidiary which engaged in the business of insurance. Accordingly, ORG does not qualify as an insurance company within the scope of section 501(c)(15).

Neither section 501(c)(15) nor the regulations thereunder define an "insurance company." For federal income tax purposes, however, the term "insurance company" has the same meaning under section 501(c)(15) as it does in Subchapter L. See H. Conf. Rep. No. 99-841, 99th Cong., 2nd Sess. (Vol.II) 370-71, reprinted in 1986-3 (Vol.4) C.B. 370-71. Under this definition, ORG does not qualify as an insurance company for the year 20XX.

Treasury Regulation § 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. Section 1.801-3(a)(1) further provides that, although 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

Internal Revenue Code. Accord Bowers v. Lawyers Mortgage Co., 285 U.S. 182, 188 (1932); see also Inter-American Life Insurance Co. v. Commissioner, 56 T.C. 497, 506-08 (1971) (where the Tax Court concluded that, because the taxpayer's primary and predominant source of income was from its investments, and because the taxpayer did not focus its primary and predominant efforts in pursuit of its insurance business, it was not an insurance company), aff'd per curiam, 469 F.2d 697 (9th Cir. 1972); Cardinal Life Ins. Co. v. United States, 300 F. Supp. 387, 392 (N.D. Tex. 1969) (holding that plaintiff was not an insurance company when the majority of its income was from dividends, interest, rent and capital gains, but instead was a personal holding company that was "seeking to remove itself from the grasp of the personal holding company provisions by claiming life insurance status through the issuance of a small and insignificant amount of insurance contracts"), rev'd on other grounds, 425 F.2d 1328 (5th Cir. 1970); Rev. Rul. 83-172, 1983-2 C.B. 107 (holding that the taxpayer was an "insurance company," as defined in §1.801-3(a)(1), notwithstanding that the taxpayer was not recognized as an insurance company for state law purposes). Accordingly, in order for an entity to be an insurance company for federal income tax purposes, its primary and predominant business activity during the year at issue must be the issuing of insurance or annuity contracts or the reinsuring of risks underwritten by another insurance company.

To qualify as an insurance company under this definition, a taxpayer "must use its capital and efforts primarily in earning income from the issuance of contracts of insurance." Industrial Life Insurance Co. v. United States, 344 F. Supp. 870, 877 (D. S.C. 1972) (emphasis in original), aff'd per curiam, 481 F.2d 609 (4th Cir. 1973), cert. denied, 414 U.S. 1143 (1974). All of the relevant facts will be considered, including but not limited to, the size and activities of any staff, whether the entity engages in other trades or businesses, and its sources of income. See Lawyers Mortgage Co., 285 U.S. at 188-90; Industrial Life Insurance Co., 344 F.Supp. at 875-77; Cardinal Life Ins. Co. v. United States, 300 F. Supp. 387, 391-92; Service Life Insurance 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 Insurance Co., 56 T.C. at 506-08.

During 20XX, ORG' primary and predominant business activity was engaging in the generation of various forms of investment income through investing and trading in securities and other capital investment oriented holdings. In fact, based on its Form 990, ORG investment income represented 83.78% of the total revenue reported by ORG for 20XX. In addition, the remaining revenue reported on ORG Form 990 for 20XX was actually not its revenue but the revenue of its wholly owned subsidiary, Subsidiary ("Subsidiary Group"). If Subsidiary paid this revenue over to ORG during the year, such payments would not constitute insurance premiums to ORG but, rather, either a return of capital, a dividend or gain from the sale of property. I.R.C. § 301. Accordingly, ORG was not an insurance company during 20XX since it was not engaged in the business of issuing insurance contracts or reinsuring the risks underwritten by another insurance company.

Moreover, the Retrocession Agreement entered into by Subsidiary and ABC Co Liability SP (the "Retrocession Agreement") represents a reinsurance arrangement with ORG wholly owned subsidiary. ORG is not a party to the Retrocession Agreement. Moreover, insurance premiums under the Retrocession Agreement that were transferred by Subsidiary to ORG do not constitute insurance premiums to ORG. Pursuant to section 301, these payments from a wholly owned subsidiary to its parent constitute either a return of capital, a dividend payment or gain from the sale of property.

Although neither the Internal Revenue Code nor the regulations define the terms "insurance" or "insurance contract," the accepted definition of "insurance" for federal income tax purposes was set forth in Helvering v. LeGierse, 312 U.S. 531, 539 (1941). There, the Supreme Court stated that "historically and commonly insurance involves risk-shifting and risk-distributing." As further clarified in case law, insurance

> "involves a contract, whereby, for adequate consideration, one party undertakes to indemnify another against a loss arising from certain specified contingencies or perils. Fundamentally and shortly, it is the contractual security against possible anticipated loss. Risk is essential and, equally so, a shifting of its incidence from one to another."

Epmeier v. United States, 199 F.2d 508, 509-510 (7th Cir. 1952). In addition, 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); Revenue Ruling 89-96, 1989-2 C.B. 114.

Risk shifting occurs when a person facing the possibility of economic loss transfers some or all of the financial consequences of the potential loss to the insurer. See Rev. Rul. 92-93, I.R.B. 1992-45 (where parent corporation purchased a group-term life insurance policy from its wholly owned insurance subsidiary, the arrangement was held to be not "self-insurance" because the economic risk of loss was not that of the parent), modified on other grounds, Rev. Rul. 20WW-31, 20WW-1 C.B. 1348. If the insured has shifted its risk to the insurer, then a loss by the insured does not affect the insured because the loss is offset by the insurance payment. See Clougherty Packing Co. v. Commissioner, 811 F.2d 1297, 1300 (9th Cir. 1987). Moreover, 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. LeGierse, 312 U.S. at 542; Rev. Rul. 89-96, 1989-2 C.B. 114.

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 a premium and set aside for the payment of such a claim. See Amerco, Inc. v. Commissioner, 979 F.2d 162 (9th Cir. 1992). Insuring many independent risks in return for numerous premiums serves to distribute risk. The insurer, by assuming numerous relatively small independent risks that can occur randomly over time, smoothes out the losses to match more closely its receipt of insurance premiums. See Clougherty Packing Co., 811 F.2d at 1300. Risk distribution necessarily entails a pooling of premiums, so a potential insured is not in significant part paying for its own risks. See Humana v. Commissioner, 881 F.2d 247 (6th Cir. 1989).

During 20XX, ORG principle business activity was engaging in various forms of investment activity, including the ownership of an insurance company. This activity did not involve any risk shifting or risk distribution. Accordingly, ORG was not an insurance company during the year 20XX because its primary and predominant business activity did not involve insurance contracts but, rather, the generation of investment income.

On December 5, 20XX, ORG materially changed its operations from what it represented in its Form 1024. In the Form 1024, ORG stated that it would directly engage in the business of insurance once its application was approved. Instead, on December 5, 20XX, ORG incorporated Subsidiary to engage in the only insurance activity it asserts qualifies it as an insurance company. This change in operation was not disclosed on its application for exemption as a planned undertaking and was never subsequently revealed to the Internal Revenue Service (the "Service") until the current audit.

ORG exemption letter clearly stated that a change in operation is to be reported to the Service. However, ORG did not report any changes in operation on its Forms 990 or otherwise. Instead, ORG claimed on its Form 990 for 20XX and 20YY that Subsidiary was its d/b/a. Accordingly, ORG has failed to provide notice to the Service of this material change in its operation as required by the April 8, 20XX exemption letter.

ORG granting of exemption was based on its representations in its Form 1024. ORG represented that it would directly engage in insurance activity, which was contingent upon its receipt of tax-exemption under section 501(c)(15). ORG change in operation was material because it changed its primary and predominant business activity, as originally indicated, from anticipated insurance activity to substantial non-insurance activities (i.e.; managing investments in securities and an insurance company).

An organization may not rely on a favorable determination letter if there has been a material change in operation inconsistent with exemption which would preclude the granting of exemption. Treas. Reg. § 601.201(n)(3)(ii). In cases where revocation is due to a material change, inconsistent with exempt status, in the character, the purpose, or the method of operation, revocation will ordinarily take effect as of the date of the material change. Rev. Proc. 90-27, 1990-1 C.C. 514. Accordingly, for the year 20XX, ORG is not an insurance company exempt from tax under section 501(c)(15) since its predominant business activity was engaging in investing activity.

The effective date of revocation is December 5, 20XX, the date that the Subsidiary was incorporated.

ORGANIZATION'S POSITION:

The results of the examination were discussed with CPA, your organization's representative. Mr. CPA indicated disagreement with the examination findings and also indicated that he will present a position upon receipt of the 30-day letter.

CONCLUSION:

ORG ("ORG") is not an insurance company exempt from tax under I.R.C. § 501(c)(15) for the taxable year 20XX. An insurance company for federal income tax purposes is a company whose primary and predominant business activity during the year is the issuing of insurance or annuity contracts or the reinsuring of risks underwritten by insurance companies. ORG was not engaged in any activity that would constitute insurance or reinsurance activities during 20XX. Instead, ORG predominant business activity during 20XX was engaging in its investment activity. Accordingly, ORG is not an insurance company for federal income tax purposes for the taxable year 20XX and, therefore, is not exempt from taxation under section 501(c)(15) for 20XX.