INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

December 03, 2007

Third Party Communication: None
Date of Communication: Not Applicable

Number: **200816029**
Release Date: 4/18/2008

Index (UIL) No.: 831.00-00, 7701.02-00, 7701.02-03
CASE-MIS No.: TAM-136636-07

Director

Taxpayer's Name:
Taxpayer's Address:

Taxpayer's Identification No
Year(s) Involved:
Date of Conference:

LEGEND:

Parent:
IC:
A:
B:
C:
D:
E:
F:
G:
H:

ISSUE(S):

Whether an entity classified as a partnership for federal income tax purposes should be considered the insured entity under a purported insurance arrangement for purposes of evaluating whether there is sufficient risk distribution to treat the arrangement as insurance for federal income tax purposes.

CONCLUSION(S):

If the entity classified as a partnership for federal income tax purposes is of the type that has a general partner(s), because the general partner(s) is ultimately liable for the liabilities of the entity, it is the general partner(s) whose risk of loss is shifted; hence it is the general partner(s) that should be considered the insured under liability coverage for purposes of evaluating whether an arrangement constitutes insurance for federal income tax purposes.

If the entity classified as a partnership for federal income tax purposes is of the type that does not have a general partner(s); that is, under applicable law no liability of the entity can in the ordinary course attach to anyone other than the entity, it is the entity that should be considered the insured under liability coverage for purposes of evaluating whether an arrangement constitutes insurance for federal income tax purposes.

FACTS:

Parent is the common parent of a group of affiliated entities classified as corporations, partnerships, and disregarded entities for federal income tax purposes. Among these entities is IC, a corporation intended to provide insurance coverage for some or all of the other member entities. IC has entered into a purported insurance arrangement with Number A of these affiliates. Of these Number A entities, Number B are corporations and account for Number C% of IC's premium income. The remaining Number D insureds are disregarded entities/partnerships which account for Number E% of IC's premium income. Among these covered entities are entities which are organized as limited partnerships under the applicable local law and classified as partnerships for federal tax purposes. Typically, these limited partnerships have one general partner and one limited partner. The general partner may be a corporation or another partnership. The ultimate general partner is a corporation that is indirectly owned by parent.

At least one involved entity is a limited liability company with more than one member.

IC provides coverage for losses arising from workers' compensation, automobile liability, and general liability.

LAW:

Neither the Code nor the regulations thereunder define the terms "insurance" or "insurance contract." The bedrock for evaluating whether an arrangement constitutes insurance is Helvering v. Le Gierse, 312 U.S. 531, 539 (1941), in which the Court stated that "historically and commonly insurance involves risk - shifting and risk - distributing" in "a transaction which involve[s] an actual 'insurance risk' at the time the transaction was executed." Insurance has been described as "involv[ing] a contract, whereby, for adequate consideration, one party agrees to indemnify another against loss arising from certain specified contingencies or perils…[I]t is contractual security against possible anticipated loss." Epmeir v. United States, 199 F.2d 508, 509-10 (7th Cir. 1952). 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] 1) involvement of an insurance risk; 2) shifting and distribution 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 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.), cert. denied, 340 U.S. 853 (1950) and must not be merely an investment risk. Le Gierse, 312 U.S. at 542; Rev. Rul. 89-96, 1989-2 C.B. 114.

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 smooths out losses to match more closely its receipt 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).

The Procedure and Administration Regulations provide that whether an organization is an entity separate from its owners for federal tax purposes is a matter of federal tax law and does not depend on whether the organization is recognized as an entity under local law. Section 301.7701-1(a). The regulations describe a business entity as any entity

[1] These principles include respecting the separateness of corporate entities, the form and substance of the transaction(s), and the relationship between the parties. Sears, Roebuck and Co. v. Commissioner, 96 T.C. 61, 101-02 (1991), aff'd in part and rev'd in part, 972 F.2d 858 (7th Cir, 1992).

recognized for federal tax purposes (including an entity with a single owner that may be disregarded as an entity separate from its owner) that is not properly classified as a trust or otherwise subject to special treatment under the Code. Section 301.7701-2(a).

Under § 301.7701-2(a), a business entity with two or more members is classified for federal tax purposes as either a corporation or a partnership. See also, §§ 301.7701-2(c)(1); 301.7701-3(b)(i).

Under § 301.7701-2(a), a business entity with only one owner is classified as a corporation or is disregarded; if the entity is disregarded, its activities are treated in the same manner as a sole proprietorship, branch, or division of the owner. See also §§ 301.7701-2(c)(2); 301.7701-3(b)(ii). Rev. Rul. 2004-77, 2004-2 C.B. 119, holds that an entity with two members under local law, one of which is disregarded for federal tax purposes, must be classified either as an association taxable as a corporation or is disregarded as separate from its owner.

In Rev. Rul. 2002-90, 2002-2 C.B. 985, 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; there were no related guarantees of any kind in favor of S; perhaps 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 arrangements between S and each of the 12 operating subsidiaries of S's parent constitute insurance for federal income tax purposes.

Rev. Rul. 2005-40, 2005-2 C.B. 4, considered X, a domestic corporation, which operated a courier transport business under, among other situations, 1) its own name (i.e., as a sole proprietorship), 2) through 12 limited liability companies of which X is the single member and which were disregarded as entities separate from X under the Procedure and Administration Regulations, or 3) through 12 limited liability companies of which X is the single member and which had elected to be classified as associations. In each situation, X (or the limited liability companies) entered into an arrangement with Y to cover an insurance risk; the arrangement was Y’s only such arrangement. The ruling holds that where X conducted the business in its own name or through the disregarded limited liability companies the arrangement did not constitute insurance for federal income tax purposes for lack of risk distribution; the arrangement did constitute insurance for federal income tax purposes in the situation where X conducted the business through limited liability companies which had elected to be classified as associations.

Under § 303 of the Uniform Limited Partnership Act,

> [a]n obligation of a limited partnership, whether arising in contract, tort, or otherwise, is not the obligation of a limited partner. A limited partner is not personally liable, directly or indirectly, by way of contribution or otherwise, for an obligation of the limited partnership solely by reason of being a limited partner, even if the limited partner participates in the management an control of the limited partnership.

Under § 404(a) of the Uniform Limited Partnership Act, "[e]xcept as otherwise provided in subsections (b) and (c) [which are not relevant here], all general partners are liable jointly and severally for all obligations of the limited partnership unless otherwise agreed by the claimant or provided by law."

One treatise observes that use of a corporate general partner in a limited partnership can permit the corporate officers to control the affairs of the limited partnership without subjecting the corporate shareholders to unlimited personal liability. J. William Callison and Maureen A. Sullivan, Partnership Law and Practice: General and Limited Partnerships, § 23:20 (2007). This same treatise also notes that while the general rule is that exhaustion of partnership assets is necessary before recourse to those of the general partner(s), at least one case has held otherwise. Id.

There is still debate whether a partnership should be characterized as a separate distinct entity or as an aggregate (conduit) of its members. See Daryll K. Jones, The Lingering Life of the Entity Theory, Tax Notes, Apr. 9, 2007, 115 Tax Notes 179, 2007 TNT 69-37.

Under § 304(a) of the Uniform Limited Liability Company Act,

> The debts, obligations, or other liabilities of a limited liability company, whether arising in contract, tort, or otherwise: 1) are solely the debts, obligations, or other liabilities of the company; and 2) do not become the debts, obligations, or other liabilities of a member or manager solely by reason of the member acting as a member or manager acting as a manager.

ANALYSIS:

Ultimately the question presented in this case is whether there is sufficient risk distribution among the insureds under the purported insurance arrangement. For this determination it is necessary to establish how many insureds there are under the arrangement and the amount of risk shifted to IC.

The *sine qua non* of insurance for federal income tax purposes is the transfer and distribution of an insurance risk of economic loss. To properly evaluate whether an arrangement constitutes insurance for federal income tax purposes, it is critical to source the insurance risk. Accordingly, we do not base our analysis on whether or not the entity is a Federal tax paying entity, such as a corporation, or is a pass through entity, such as a partnership.

In the context of limited partnerships, the general partner(s) is exposed to liability in excess of the partnership assets; particularly with regard to liability risks, the general partner(s) is vulnerable to lose more than its equity in the partnership. Accordingly, it is appropriate to view the general partner(s) as being the insured. To avoid duplication resulting from correlated losses, for purposes of this analysis, only the general partners should be counted as the "insured(s)", not the limited partner(s) nor the limited partnership itself.

Though it would appear that this mode of analysis is subject to the criticism that it ignores the risk of loss sourced to the limited partner(s), upon close examination it does not. In the context of a corporation, there is no dispute that "the insured" is *the corporation*, not its shareholder(s). Compensating the corporation for a covered loss has the economic effect of compensating the shareholders for the otherwise resulting diminution of their equity. Similarly, because the general partner(s) bears the maximum exposure to loss, except for coverage limited to loss in excess of partnership assets (query whether such coverage is written), compensating the general partner(s) should have the economic effect of compensating the partnership hence the limited partners.

As with corporations, because the exposure to liability of any member of a multi-member limited liability company is limited to that member's equity in the company, it is appropriate to view the company as being insured.

Therefore, when evaluating whether an arrangement providing liability coverage that involves a limited partnership constitutes insurance for federal income tax purposes, unless local law otherwise subjects limited partners to the same degree of liability risk exposure as the general partner(s), the general partner(s) should be considered the insured entity. Similarly, with regard to a multi-member limited liability company, unless local law otherwise subjects members to exposure akin to that of a general partner or sole proprietor, the company should be considered the insured entity.

Our analysis has also rejected the argument that even though some of the partnerships have general partners that may be liable for obligations of the partnerships does not cause the general partner to be the insured party because the likelihood that the general partner in each partnership would bear the insured risks is extremely remote due the to fact that the net assets of each partnership are generally sufficient to satisfy virtually any creditor's claim. This argument fails to take into account that at the time a claim arises the partnership may not have the assets it currently possesses which is

exactly the moment when an "insurance" policy would step in to pay a loss. Nor does it account for the size and frequency of losses.

CAVEAT(S):

With respect to determining the number of insureds in this case, the analysis of Rev. Rul. 2005-40 would apply to the limited liability companies and the holding of this technical advice memorandum would look to the general partners of the partnerships. Consequently, there appears to be a total of Number F insureds with Number G insureds accounting for Number H% premiums of IC (treating the owner of the entity that is at risk as paying the premium for purposes of determining risk distribution). No advice is expressed on any issue other than that articulated herein; no advice was requested and none is expressed whether the arrangement with IC involves an insurance risk or whether the arrangement involves the requisite risk distribution.

A copy of this technical advice memorandum is to be given to the taxpayer(s). Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.