PLR 201126036 -- 501(c)(15) Lacks Risk Distribution

by **Jay** » Thu Jul 07, 2011 11:16 am

PLR 201126036 - Section 501 - Exemption From Tax on Corporations, Certain

Trusts, etc.

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

TAX EXEMPT AND GOVERNMENT ENTITIES DIVISION
Number: 201126036

Release Date: 7/1/2011

Contact Person: Identification Number: Date: April 6, 2011

Contact Number: UIL501.15-00

Employer Identification Number:

Form Required To Be Filed: Tax Years:

Dear [redacted data]:

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).

We made this determination for the following reason(s):

There is an insufficient number of insureds to provide for an adequate premium-pooling base. In addition, your risk is too heavily concentrated in just a few insureds. As a result, your business lacks one of the principal elements of insurance, risk distribution. Thus, because you do not qualify as an insurance company, you do not meet the statutory requirement for exemption under section 501(c) (15) of the Code.

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,

Director, Exempt Organizations

Enclosure

Notice 437

Redacted Proposed Adverse Determination Letter

Redacted Final Adverse Determination Letter

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

TAX EXEMPT AND GOVERNMENT ENTITIES DIVISION Date: September 1, 2010

UIL: 501.15-00

Contact Person: Identification Number: Contact Number:

FAX Number:

Employer Identification Number:

Legend: Date A = Offshore B = C =

D = E = F =

G = H = I =

J = K = L = M = ff =

gg =

hh =

ii = jj = kk = MM = nn = N =

O =

Q = R = T = U = V= W = X = Y=

Z = aa = bb = cc = dd =

ee =

Dear [redacted data]:

We have considered your application for recognition of exemption from Federal Income tax under Internal Revenue Code section 501(a). Based on the information provided, we have concluded that you do not qualify for exemption under section 501(c)(15) of the Code.

Facts:

You were incorporated on Date A in Offshore B. You are in the business of providing certain commercial casualty and property insurance-type services. You also "reinsure" certain contracts as described below. You filed an election under section 953(d) of the Code which allows an election by a foreign insurance company to be treated as a domestic corporation.

You are wholly owned by D. You have only one class of stock composed of E shares of no par value stock. Out of these E shares, you issued F shares to D. The consideration paid for these shares was G. H and I serve as your only corporate officers and directors. H serves as your director, chief executive officer, president, secretary and assistant treasurer. I serves as your director, vice president, treasurer and assistant secretary. Neither H nor I holds financial interests in any other insurance companies. Moreover, neither H nor I has any agreement or relationship with any of the shareholders of the insurance companies with which you conduct business.

You have employed J as your resident manager for an annual compensation estimated to be less than K.

You operate primarily to provide casualty and property "insurance" coverage to M. M is made up of ff entities. There is only a description of one entity provided in your application. This entity is gg, which is not the precise name of any one of the ff entities. It is described as one of the largest privately owned structural steel service centers in hh. The application indicates that the ff entities are related or affiliated businesses. By "related" or "affiliated" is meant persons related to H for which you may provide direct written coverages. H owns jj% of the common stock of each of the ff entities that compose M. N also owns jj% of the common stock of each of the ff entities that compose M.

In year C, you wrote direct-written "insurance" contracts to M titled: (1) Special Risk - Product Recall Insurance Policy, (2) Special Risk - Regulatory Changes Insurance Policy, (3) Special Risk - Expense Reimbursement Insurance Policy, (4) Special Risk - Punitive Wrap Liability Insurance Policy, (5) Excess Pollution Liability Insurance Policy, (6) Special Risk-Tax Liability Insurance Policy for C, (7) Special Risk - Tax Liability Insurance Policy for ii, (8) Special Risk -Tax Liability Insurance Policy for kk, (9) Special Risk - Deductible/Self Insured Retention Expense Reimbursement Insurance Policy, (10) Special Risk - Product Pricing Insurance Policy, (11) Special Risk - Loss of Major Supplier(s) Insurance Policy and (12) Special Risk -Loss of Services Insurance Policy.

In addition to the L direct-written "insurance" contracts issued by you to M, you and MM entered into an agreement titled "Joint Underwriting Stop Loss Endorsement." MM is not related to you, D, M, H, I, N or O, the other lead insurer on the "insurance" contracts with M. You represent that MM is a regulated insurer. It appears that under this agreement, you are responsible for payment of claims up to certain specified thresholds. If the thresholds are met, then MM becomes liable for payment of claims up to certain specified limits. If the specified limits for MM's payment of claims are exceeded, then you again become liable. It also appears that for each of the above-referenced contracts, you receive Q% of the total premiums and O receives Q% of the total premiums. MM receives R% of the total premiums.

During year C, you entered into two types of reinsurance arrangements. In the first arrangement, you assumed reinsurance contracts from MM. The primary issuers on these contracts are unaffiliated insurance companies that underwrite credit-type policies (credit property, credit disability, and/or credit life) and policies for vehicle service contracts. For year C, you received $S in "premium" income from this arrangement.

The second arrangement is referred to by you as a "reinsurance risk pooling program." In this arrangement, you participate in a "reinsurance risk pool" with several other unrelated insurance companies ("pool participants"). The risk pool is operated by MM. Each pool participant has one or more affiliated operating entities for which it underwrites insurance coverage (generally casualty type coverage). MM insures a portion of the direct insurance underwritten by the pool participants using a so-called "stop loss" endorsement. MM currently participates in over T insurance policies with more than U insureds. MM blends together its direct-written insurance and then reinsures the entire book on a quota-share basis with each of the pool participants. During year C, you received $V in "premiums" with respect to this second arrangement.

Your gross income totaled $W for year C which is $X of direct written premiums and $Y of reinsurance assumed and pooled premiums

Of your total premium income for year C, Z% is from M (assuming you receive Q% of the contract premiums as previously discussed), aa% is from the first reinsurance arrangement, and bb% is from the "reinsurance risk pooling program." You have decided to reserve conservatively during the policy period at cc% of its direct written premiums.

For year C, your assets totaled $dd, and total capital equaled $G.

Law:

Section 501(c)(15) of the Code recognizes as exempt insurance companies or associations other than life (including interinsurers and reciprocal underwriters) if the net written premium (or, if greater, direct written premiums) for the taxable year do not exceed $350,000. For years 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.

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. 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.

Neither the Code nor the regulations define the terms "insurance" or "insurance contract." The standard for evaluating whether an arrangement constitutes insurance is Helvering v. LeGierse, 312

U.S. 531 (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 "involving] a contract, whereby, for adequate consideration, one party agrees to indemnify another against loss arising from certain specified contingencies or perils. Epmeier v. United States, 199 F.2d 508, 509-10 (7th Cir. 1952). Insurance is contractual security against possible anticipated loss, id. 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 e.g., AMERCO. Inc. v. Commissioner. 979 F.2d 162, 164-65 (9th Cir. 1992), affg. 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. 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. LeGierse. 312 U.S. at 542; Rev. Rul. 89-96, 1989-2 C.B. 114.

Rev. Rul. 2007-47, 2007-30 I.R.B. 127, provides that an arrangement that provides for the reimbursement of inevitable future costs does not involve the requisite insurance risk for purposes of determining (1) whether the amount paid for the arrangement is deductible as an insurance premium and (2) whether the assuming entity may account for the arrangement as an "insurance contract" for purposes of subchapter L of the Code. In Rev. Rul. 2007-47, a domestic corporation engaged in a business process that was inherently harmful to people and property. Applicable government regulations require the corporation to take action to remediate the harm and, therefore, the domestic corporation will incur future cost to restore its business location. There is no uncertainty that future costs will be incurred. The domestic corporation entered into a contract with a domestic insurance company to be reimbursed for its future costs. The arrangement had no limits on its duration. Citing and amplifying Rev. Rul. 89-96, 1989-2 C.B. 114, Rev. Rul. 2007-47 holds that this was not an insurance arrangement. Arrangements that are entered into to manage losses that are at least substantially certain to occur, or that are not the result of fortuitous events, do not constitute insurance. The fortuity principle is central to the notion of what constitutes insurance. Rev. Rul. 2007- 47 holds that an arrangement that purports to be an insurance contract that lacks the requisite insurance risk, or fortuity, may instead be characterized as a deposit arrangement, a loan or a contribution to capital, an option or indemnity contract based on the substance of the arrangement

between the parties.

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 a payment from the insurer. See Rev. Rul. 60-275, 1960-2 C.B. 43 (risk shifting not present where subscribers, all subject to the same flood risk, agreed to coverage under a reciprocal flood insurance exchange).

Risk distribution incorporates the statistical phenomenon known as the law of large numbers. The concept of risk distribution "emphasizes the pooling aspect of insurance: that it is the nature of an insurance contract to be part of a larger collection of coverages, combined to distribute risks between insureds." AMERCO and Subsidiaries v. Commissioner. 96 T.C. 18, 41 (1991), aff'd. 979 F.2d 162 (9th Cir. 1992). In Treqanowan. 183 F.2d at 291, the court quoting Note, The New York Stock Exchange Gratuity Fund: Insurance That Isn't Insurance, 59 Yale L.J. 780, 784 (1950), explained that "[b]y diffusing the risks through a mass of separate risk shifting contracts, the insurer casts his lot with the law of averages. The process of risk distribution, therefore, is the very essence of insurance." See also Beech Aircraft Corp. v. United States, 797 F.2d 920, 922 (10th Cir. 1986), (risk distribution "means that the party assuming the risk distributes his potential liability, in part, among others"); Ocean Drilling & Exploration Co. v. United States. 988 F.2d 1135, 1153 (Fed. Cir. 1993)("[r]isk distribution involves spreading the risk of loss among policyholders").

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 over time, the insurer smoothes out losses to match more closely its receipt of premiums. Cloughertv 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).

In Situation 1 of Rev. Rul. 2002-89, 2002-2 C.B. 984, S, a wholly owned subsidiary of P, a domestic parent corporation, entered into an annual arrangement with P whereby S provided coverage for P's professional liability risks. The liability coverage S provided to P accounted for 90% of the total risks borne by S. Under the facts of Situation 1 the Service concluded that insurance did not exist for federal income tax purposes. On the other hand, in Situation 2 of Rev. Rul. 2002-89, the premiums that S received from the arrangement with P constituted less than 50% of S's total premiums for the year. Under the facts of Situation 2, the Service reasoned that the premiums and risks of P were pooled with those of unrelated insureds and thus the requisite risk shifting and risk distribution were present. Accordingly, under Situation 2, the arrangement between P and S constituted insurance for federal income tax purposes.

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 and there were no related guarantees of any kind in favor of S. 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 arrangement between S and each of the 12 operating subsidiaries of S's parent constitutes insurance for federal income tax purposes.

Situation 1 of Rev. Rul. 2005-40, 2005-40 I.R.B. 4, describes a scenario where a domestic corporation operated a large fleet of automotive vehicles in its courier transport business covering a large portion of the United States. This represented a significant volume of independent, homogeneous risks. For valid non-tax business purposes, the transport company entered into an insurance arrangement with an unrelated domestic corporation, whereby in exchange for an agreed amount of "premiums," the domestic carrier "insured" the transport company against the risk of loss arising out of the operation of its fleet in the conduct of its courier business. The unrelated carrier received arm's length premiums, was adequately capitalized, received no guarantees from the courier transport company and was not involved in any loans of funds back to the transport company. The transport company was the carrier's only "insured." While the requisite risk-shifting was seemingly present, the risks assumed by the carrier were not distributed among other insureds or policyholders. Therefore, the arrangement between the carrier and the transport company did not constitute insurance for federal income tax purposes.

The facts in Situation 2 of Rev. Rul. 2005-40 mirror the facts of Situation 1 except that in addition to its arrangement with the transport company, the carrier entered into a second arrangement with another unrelated domestic company. In the second arrangement, the carrier agreed that in exchange for "premiums," it would "insure" the second company against its risk of loss associated with the operation of its own transport fleet. The amount that the carrier received from the second agreement constituted 10% of the total amounts it received during the tax year on a gross and net basis. Thus, 90% of the carrier's business remained with one insured. The revenue ruling concluded that the first arrangement still lacked the requisite risk distribution to constitute insurance even though the scenario involved multiple insureds.

In Situation 4 of Rev. Rul. 2005-40, 12 LLCs elected classification as associations, each contributing between five and 15% of the insurer's total risks. The Service concluded that this transaction constituted insurance for federal income tax purposes.

Analysis:

The principal concern with regard to your activities is whether there is sufficient risk distribution. As discussed above, the idea of risk distribution involves some mathematical concepts. For example, risk distribution is said to incorporate the statistical phenomenon known as the "law of large numbers" whereby distributing risks allows the insurer to reduce the possibility that a single costly claim will exceed the amount taken in as premiums. The concept hinges on the assumption of "numerous relatively small" and "independent risks" that "occur randomly over time." Cloughertv Packing Co., supra.

As discussed, in Rev. Rul. 2002-90, the Service concluded that insurance existed where 12 insureds each contributed between five and 15% to the insured's total risks. Similarly, in Situation 4 of Rev. Rul. 2005-40, the Service concluded that insurance existed where 12 LLCs, electing classification as associations, each contributed between five and 15% of the insurer's total risks. Moreover, in Situation 2 of Rev. Rul. 2002-89, supra, the Service concluded that insurance existed where a wholly owned subsidiary insured its parent, but the arrangement represented less than 50% of the insurer's total risk for the year.

The present facts are similar to those under Situation 1 of Rev. Rul. 2002-89, supra, and Situation 2 of Rev. Rul. 2005-40, supra. In Situation 1 of Rev. Rul. 2002-89, supra, the liability coverage provided to the parent corporation by its wholly owned subsidiary accounted for 90% of the total risks borne by the subsidiary. Similarly, in Situation 2 of Rev. Rul. 2005-40, supra, a second insured contributing 10% of the insurer's risks was added to the single-insured scenario of Situation 1. The Service concluded in both of the above scenarios that insurance did not exist because there lacked a sufficient number of insureds to provide for an adequate premium pooling base.

Assuming that all of your contracts do constitute insurable risks, Z% of your total risks for the C tax year are with the ee insureds that compose M. In your case, the fact pattern for the year in question presents a heavy concentration of risks in just a few insureds. In our view, such concentration of risk does not allow the insurer to reduce the possibility that a single costly claim will not exceed the amount of premiums taken in from such a limited number of insureds. Therefore, there is not sufficient risk distribution to conclude that insurance exists. Consequently, you do not qualify as an insurance company.

You appear to rely on Harper Group & Subsidiaries v. Commissioner, 96 T.C. 45 (1991) to support your argument that you qualify as an insurance company. You believe that the court in Harper Group holds that where a single-insured paid 71% of the total premium, risk distribution was sufficient to qualify the arrangement as insurance. Because less than 70% of your risk is from M, you assert that the arrangement should qualify as insurance under Harper Group. This is a misunderstanding of Harper Group. In Harper Group, 67% to 71 % of the total premiums received for the years at issue were not related to a single policyholder. Rather, the 67% to 71% were the total percentages received from all related policyholders, including brother-sister corporations (a total of 13 entities). The court's analysis in Harper Group must be read in its entirety and all the facts and circumstances must be considered, Le. that there are 13 entities making up the nearly two thirds risk concentration in all the years at issue. The Service took a similar position in Rev. Rul. 2002-90, concluding that insurance existed in an arrangement involving 12 insureds, each contributing between five and 15% of the insurer's total risks. Moreover, in situation 4 of Rev. Rul. 2005-40, the Service concluded that insurance existed where 12 LLCs, electing classification as associations, each contributed between five and 15% of the insurer's total risks. Also, in situation 2 of Rev. Rul. 2002-89, the Service concluded that insurance existed where a wholly owned subsidiary insured its parent, but the arrangement represented less than 50% of the insurer's total risk for the year.

Based on the above discussion of the facts of Harper Group and the cited revenue rulings, the court's analysis in Harper Group supports the Service's position that you do not qualify as an insurance company.

Conclusion:

Because you do not qualify as an insurance company for federal income tax purposes, you fail to meet the requirement of section 501(c)(15) of the Code. Therefore, you do not qualify for exemption under section 501(c)(15) and 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

SE:T:EO:RA:T:3, PE-3L7

Attn:

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,

Director, Exempt Organizations

Rulings & Agreements