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

TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

Date: FEB 24 2004

Contact Person:
[redacted]
Identification Number:
[redacted]
Contact Number:
[redacted]

[redacted]

Employer Identification Number: [redacted]

Dear Applicant:

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

Your corporation, hereinafter referred to as [redacted], was incorporated on [redacted], in the [redacted]. [redacted] insures casualty risks, specifically medical malpractice insurance, associated with [redacted], and the professional staff at [redacted], hereinafter referred to as the insured.

[redacted]'s operations are conducted by [redacted], a professional insurance management firm located in the [redacted]. For an annual fee, [redacted] approves the issuance of insurance contracts, receives premium payments, approves settlement and payment of claims, approves insureds, and maintains proper regulatory filings in the [redacted].

The ownership arrangement is as follows: The insured, [redacted] and [redacted], is owned 100% by [redacted]. [redacted] is owned by [redacted] (50%) and by [redacted] (50%).

There was one insurance policy written to the insured in [redacted], in which a premium of $[redacted] was paid.

[redacted] filed an election with the Service under section 953(d) of the Code to be treated as a domestic organization for federal income tax purposes.

[redacted]

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."

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. See Bowers v. Lawyers Mortgage Co., 285 U.S. 182 (1932).

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

Risk shifting occurs if a person facing the possibility of an economic loss transfers some or all of the financial consequences of the potential loss to the insurer, such that a loss by the insured does not affect the insured because the loss is offset by the insurance payment. Risk distribution incorporates the statistical phenomenon known as the law of large numbers. Distributing risk allows the insurer to reduce the possibility that a single costly claim will exceed the amount taken in as premiums and set-aside for the payment of such a claim. By assuming numerous relatively small, independent risks that occur randomly over time, the insurer smoothes out losses to match more closely its receipt of premiums. Clougherty Packing Co. v. Comm'r., 811 F.2d 1297, 1300 (9th Cir. 1987). Risk distribution necessarily entails a pooling of premiums, so that a potential insured is not in significant part paying for its own risks. See Humana, Inc. v. Comm'r., 881 F.2d 247, 257 (6th Cir. 1989).

In Humana, the United States Court of Appeals for the Sixth Circuit held that arrangements between a parent corporation and its insurance company subsidiary did not constitute insurance for federal income tax purposes. The court also held, however, that arrangements between the insurance company subsidiary and several dozen other subsidiaries (operating an even larger number of hospitals) qualified as insurance for federal income tax purposes because the requisite risk shifting and risk distribution were present. But see Malone & Hyde, Inc. v. Comm'r, 62 F.3d 835 (6th Cir. 1995) (concluding the lack of a business purpose, the undercapitalization of the offshore captive insurance subsidiary and the existence of related party guarantees established that the substance of the transaction did not support the taxpayer's characterization of the transaction as insurance). In Kidde Industries, Inc. v. U.S., 40

[redacted]

Fed. Cl. 42 (1997), the United States Court of Federal Claims concluded that an arrangement between the captive insurance subsidiary and each of the 100 operating subsidiaries of the same parent constituted insurance for federal income tax purposes. As in Humana, the insurer in Kidde insured only entities within its affiliated group during the taxable years at issue.

No court has held that a transaction between a parent and its wholly owned subsidiary satisfies the requirements of risk shifting and risk distribution if only the risks of the parent are "insured." See Stearns-Roger Corp. v. U.S., 774 F.2d 414 (10th Cir. 1985); Carnation Co. v. Comm'r., 640 F. 2d 1010 (9th Cir. 1981), cert. denied 454 U.S. 965 (1981). However, courts have held that an arrangement between a parent and its subsidiary can constitute insurance because the parent's premiums are pooled with those of unrelated parties if (i) insurance risk is present, (ii) risk is shifted and distributed, and (iii) the transaction is of the type that is insurance in the commonly accepted sense. See, e.g., Ocean Drilling & Exploration Co. v. U.S., 988 F.2d 1135 (Fed. Cir. 1993); AMERCO, Inc. v. Comm'r., 979 F.2d 162 (9th Cir. 1992).

In Clougherty Packing Co. v. Comm'r, 811 F.2d 1297 (9th Cir. 1987), Clougherty Packing purchased workers' compensation insurance from an unrelated insurer who then reinsured with Lombardy Insurance Corporation, a wholly owned subsidiary of one of Clougherty Packing's wholly owned subsidiaries (a second tier subsidiary). Lombardy had no business other than that attributable to the reinsurance of Clougherty's workers' compensation liabilities. As stated in Clougherty, several courts outside of the 9th circuit have addressed the captive insurance issue, and none has found that a policy provided by a wholly owned subsidiary that exists solely for the purpose of providing insurance to its parent constitutes insurance. Accordingly, as stated in the court's conclusion, an insurance agreement between parent and captive does not shift the parent's risk of loss and is not an agreement for "insurance." Premiums paid by the parent to the captive whether directly or through an unrelated insurer, may not be deducted by the parent as insurance premiums. See also, Carnation Co. v. Comm'r, 640 F.2d 1010 (9th Cir. 1981), where the court held there was no risk shifting or risk distribution with respect to the risks carried or retained by the parent's wholly-owned subsidiary.

In Malone & Hyde, Inc. v. Comm'r, T.C.M. 1989-604, rev'd and remanded, 62 F.3d 835 (6th Cir. 1995), the sixth circuit concluded that the captive insurer was a sham, and that the payments at issue were therefore not deductible as insurance premiums. The taxpayer and its operating subsidiaries purchased insurance from a commercial insurer, which then reinsured a significant portion of those risks with the taxpayer's captive insurance subsidiary. The commercial insurer retained a portion of the premiums received from the taxpayer and paid the remainder to the captive subsidiary as a reinsurance premium. The taxpayer claimed deductions for the insurance premiums paid to the commercial insurer.

In Rev. Rul. 2002-89; 2002-52 I.R.B. 984, the Service provided guidance on whether arrangements between a parent and a subsidiary insurance company qualified as an insurance arrangement and whether premiums paid were deductible under section 162 of the Code. Specifically, Situation 1 described a domestic corporation that entered into an annual arrangement with its wholly-owned insurance subsidiary. In doing so, the subsidiary either insures or reinsures the liability risks of the parent corporation. All business is maintained

[redacted]

separately and the parent does not guarantee the subsidiary's risks. Also, 90 percent of the total premiums are received from the parent corporation on both a gross and net basis. The Service pointed out that when the total risk and liability coverage is more than 90 percent for the subsidiary; there is no risk shifting and risk distribution. Accordingly, the Service held that there was no insurance arrangement and that amounts paid by the parent to the subsidiary were not deductible under section 162.

Rev. Rul. 2002-90, 2002-52 I.R.B. 985, describes a holding company owning stock of 12 domestic subsidiaries. The holding company formed a wholly-owned insurance subsidiary to directly insure the liability risks of the 12 subsidiaries of the holding company. The 12 subsidiaries are charged arms-length premiums, which are established according to customary industry rating formulas. None of the operating subsidiaries have liability coverage for less than 5%, nor more than 15%, of the total risk insured by the wholly-owned insurance subsidiary. There are no parental (or other related party) guarantees of any kind, nor does the insurance subsidiary loan any funds to the holding company or to the 12 operating subsidiaries. The liability risks of the 12 subsidiaries are shifted to the insurance company. The premiums of the subsidiaries are pooled such that a loss by one operating subsidiary is borne, in substantial part, by the premiums paid by others. Therefore, the Service held that the arrangements between the insurance company and the 12 subsidiaries of the holding company constitute insurance.

ANALYSIS:

We conclude that the information supplied does not demonstrate that the insured has transferred to [redacted] an insurance risk which has been distributed. Accordingly, we conclude that the arrangement involving the insured and [redacted] does not constitute insurance for federal income tax purposes. Because [redacted]'s only business is this arrangement, we conclude that it is not an insurance company for federal income tax purposes. Because [redacted] is not an insurance company for federal income tax purposes, it does not qualify for exemption under section 501(c)(15).

In reaching our conclusion that there is no risk distribution, the economic consequences of the captive insurance arrangement to the "insured" party is examined to see if that party has, in fact, distributed the risk.

Since all of [redacted]'s premiums – both gross and net – are earned from the arrangement involving the insured, there is no risk distribution. Similarly, all of the risks [redacted] seeks to bear are attributable to the arrangement involving the insured. Therefore, there is no distribution of risk between the two entities. To the contrary, such an arrangement lacks the requisite risk shifting and risk distribution to constitute insurance for federal tax purposes. See Rev. Rul. 2002-90, 2002-52 I.R.B. 985.

Accordingly, the arrangement between the insured and [redacted] is not an insurance arrangement for federal income tax purposes. Because this arrangement constitutes all of [redacted]'s business activities, the primary and predominant business activity of [redacted] is not issuing insurance or annuity contracts or the reinsuring of risks underwritten by insurance companies. Accordingly, [redacted] is not an insurance company for federal income tax purposes.

[redacted]

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 protest this ruling if you believe it is incorrect. To protest, you should submit a statement of your views to this office, with a full explanation of your reasoning. This statement, signed by one of your officers, must be submitted within 30 days from the date of this letter. You also have a right to a conference in this office after your statement is submitted. You must request the conference, if you want one, when you file your protest statement. If you are to be represented by someone who is not one of your officers, that person will need to file a proper power of attorney and otherwise qualify under our Conference and Practices Requirements.

If we do not hear from you within 30 days, this ruling will become final and a copy will be forwarded to the Ohio Tax Exempt and Government Entities (TE/GE) office. Thereafter, any questions about your federal income tax status should be directed to that office, either by calling 877-829-5500 (a toll free number) or sending correspondence to: Internal Revenue Service, TE/GE Customer Service, P.O. Box 2508, Cincinnati, OH 45201.

When sending additional letters to us with respect to this case, you will expedite their receipt by using the following address:

Internal Revenue Service
Attn: [redacted]
1111 Constitution Ave, N.W.
Washington, D.C. 20224

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

Sincerely,

(signed) [redacted]

[redacted]
Manager, Exempt Organizations
Technical Group 3