

Office of Chief Counsel
Internal Revenue Service
memorandum

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to: Director, SB/SE Compliance Area 8
SE:S:C

from: Mark S. Smith, Chief, Branch 4
Office of Associate Chief Counsel
(Financial Institutions and Products) CC:FIP:B04

subject: Captive "Insurance" Arrangements involving Disregarded Entities

LEGEND

Taxpayer =

Captive =

State 1 =

State 2 =

n =

p =

This Chief Counsel Advice is being written concerning a matter involving Taxpayer, who is in your audit jurisdiction, which has come to our attention. This advice may not be used or cited as precedent.

We are offering you legal advice on (1) whether certain indemnity arrangements between n operating LLCs that are proposed to be formed and Captive are insurance contracts for federal tax purposes and on (2) whether Captive will be taxable as an insurance company other than life under § 831(a) of the Internal Revenue Code.

Taxpayer is a multimember LLC organized under the LLC law of State 1. Taxpayer is closely held with p members. The members are not personally liable for Taxpayer's debts.

Currently, Taxpayer provides professional services to its clients in n locations. The n locations are not individually organized, incorporated, or legally separate. Taxpayer, however, views their operations as autonomous; separate accounting records are kept and the employees stationed at one facility do not provide service at the other facilities. Taxpayer obtains insurance from commercial insurance companies for the risks incurred by the n operating branches.

Taxpayer proposes to restructure its operations. It will form n single member LLCs ("operating LLCs"). Taxpayer will be the single member of each operating LLC. Taxpayer will transfer the assets, liabilities, and operations relating to the services provided by each of its branches to one of the operating LLCs in return for the ownership interest in the LLC. Taxpayer will not be personally liable for the debts of any of the operating LLCs. For federal tax purposes, the operating LLCs will keep their default classification; they will be disregarded as entities separate from their owner. See § 301.7701-3(b)(1)(ii) of the Procedure and Administration Regulations.

The members of Taxpayer propose to form Captive, a captive insurance company under the laws of State 2. The p members of Taxpayer will provide capital to Captive in return for Captive's stock; they will own Captive's stock in the same proportion as their ownership interest in Taxpayer.

Captive will enter into contracts with the operating LLCs to indemnify them against claims ("indemnification arrangements"). These indemnification arrangements are represented to be valid insurance contracts under state law, and are represented to be for a valid nontax business purpose. In general, Taxpayer has made representations similar to those in Rev. Rul. 2002-90, 2002-2 C.B. 985. Taxpayer represents that all of Captive's indemnity arrangements will be with the operating LLCs. Also, Taxpayer represents that the maximum percentage of liability coverage provided by Captive to any one of the operating LLCs compared to the total amount of indemnity risks assumed by Captive will not be greater than 15 percent. (Taxpayer did not make a representation concerning the minimum percentage of risks that would be accounted for by any one of the operating LLCs.)

An indemnity arrangement must involve both risk shifting and risk distribution to be insurance under federal tax law. Helvering v. Le Gierse, 312 U.S. 531 (1941); Rev. Rul. 2002-89, 2002-2 C.B. 984; Rev. Rul. 2002-90 at 985.

Both Rev. Rul. 2002-89 at 984, and Rev. Rul. 2002-90 at 985, state, "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)."

For purposes of federal tax law, the n operating LLCs are disregarded as entities separate from Taxpayer, and their activities are treated in the same manner as a branch or division of Taxpayer. See § 301.7701-3(b)(1) (ii) and § 301.7701-2(a) of the Regulations. Accordingly, each of the indemnity arrangements is treated as being between Taxpayer and Captive. See *Kidde Industries, Inc. v. United States*, 40 Fed. Cl. 42 (1997). Since there is only one purported insured, the necessary risk distribution is absent from these arrangements, leading to the conclusion that they are not insurance contracts for federal tax purposes. Consequently, we are adverse to Taxpayer's request for a ruling that it is an insurance company other than life taxable under § 831(a) of the Code.

This writing may contain privileged information. Any unauthorized disclosure of this writing may undermine our ability to protect the privileged information. If disclosure is determined to be necessary, please contact this office for our views.

Please call (202) 622-3970 if you have any further questions.