DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
230 South Dearborn Street
Chicago, IL 60304

Number: **200634049**
Release Date: 8/25/2006
Date: December 9, 2005
UIL: 501.15-01

X=Taxpayer's Name
Y=Taxpayer's Address
Date 1=
Date 2=
A = Taxpayer Advocate information

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 years of the examination, you were not operated as an " " within the meaning of I.R.C. § 501(c) (15) of the Internal Revenue Code. Your exempt status is revoked effective Date 1.

In our letter to you dated July 29, 2005, we provided you with a written report which explained our adjustments and advised of appeals procedures and asked you to respond within 30 days in the event you wanted to take advantage of those procedures. You agreed to our determination by signing Form 6018-A, Consent to Proposed Action on Date 2.

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 the attached Publication 892, Exempt Organization Appeal Procedures for Unagreed Issues.

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:

A

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 Ramirez
Director, EO Examinations

Enclosures:
Publication 892
Form 6018-A

TAX EXEMPT AND GOVERNMENT ENTITIES DIVISION

DEPARTMENT OF THE TREASURY
Internal Revenue Service

A=Taxpayer Name and Address

UIL: 501.15-01

Taxpayer Identification Number:

Form:
990
Tax Year(s) Ended:

Person to Contact/ID Number:

Contact Numbers:
Telephone:
Fax:

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.

If you do not agree with our position you may appeal your case. The enclosed Publication 3498, *The Examination Process,* explains how to appeal an Internal Revenue Service (IRS) decision. Publication 3498 also includes information on your rights as a taxpayer and the IRS collection process.

If you request a conference, we will forward your written statement of protest to the Appeals Office and they will contact you. For your convenience, an envelope is enclosed.

If you and Appeals do not agree on some or all of the issues after your Appeals conference, or if you do not request an Appeals conference, you may file suit in United States Tax Court, the United States Court of Federal Claims, or United States District Court, after satisfying procedural and jurisdictional requirements as described in Publication 3498.

You may also request that we refer this matter for technical advice as explained in Publication 892, *Exempt Organization Appeal Procedures for Unagreed Issues*. If a determination letter is issued to you based on technical advice, no further administrative appeal is available to you within the IRS on the issue that was the subject of the technical advice.

If you accept our findings, please sign and return the enclosed Form 6018, *Consent to Proposed Adverse Action*. We will then send you a final letter modifying or revoking exempt status. If we do not hear from you within 30 days from the date of this letter, we will process your case on the basis of the recommendations shown in the report of examination and this letter will become final. In that event, you will be required to file Federal income tax returns for the tax period(s) shown above. File these returns 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:

Internal Revenue Service
Office of Taxpayer Advocate

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,

Rosie C. Johnson
Director, EO Examinations

Enclosures:
Publication 892
Publication 3498
Form 6018
Report of Examination
Envelope

I. ISSUES:

A. Is A, ("A"), an exempt from tax pursuant to I.R.C. § 501(c)(15) for the taxable years Year1, Year2, Year3, and Year4?

1. Definition of an Insurance Company

i. A Failed to Use its Capital and Efforts Primarily to Earn Income from its Insurance Activity

2. A Was Not Issuing Insurance Contracts or Reinsuring the Risks of Others During Year1, Year2, Year3, and Year4

i. Workers' Compensation
ii. Deductible Reimbursement Policies for Auto Physical Damage, Crime, and Employment Practices Liability
iii. Representations and Warranties

B. Does A, a domestic company, continue to qualify for exemption from federal income tax as an organization described in I.R.C. § 501(c)(15)?

1. A Is Not Described in Section 501(c)(15) During the Years Under Exam

2. A Cannot Rely on Its Determination Letter

3. Section 7805(b) Relief

II. FACTS:

A. A's Income Statement

A reported the following on its Income Statement for the taxable years Year1, Year2, Year3 and Year4:

	Year1	Year2	Year3	Year4
Receipts				

886A	Department of the Treasury - Internal Revenue Service **Explanation of Items**	Schedule No. or Exhibit
Name of Taxpayer **A**		**Year/Period Ended** Year 1 Year 2 Year 3

Premiums Earned	$53,174	$ 300,000	$ 300,000	$ 300,000
Other Insurance Income	-0-	40,238	-0-	-0-
Interest on Savings	-0-	-0-	-0-	-0-
Dividends and Interest From Securities	101,340	68,035	124,293	341,128
Partnership Income or (Loss)	-0-	(460,016)	(641,511)	(326,329)
Total Revenue	$154,514	($ 51,743)	$(217,218)	$ 314,799
Percentage Premiums	34.4%			
Expenses				
General and Admin Costs	$ 59,458	$ 116,295	$ 71,838	$ 66,253
Loss and Underwriting Costs	78,505	(108,582)	5,000	7,500
Change in UPR	(128,571)	-0-	-0-	
Total expenses$	$ 9,392	$ 7,713	$ 76,838	$ 73,753

B. A's Balance Sheet

A reported the following on its Balance Sheets for the taxable years Year1, Year2, Year3, and Year4.

	Year1	Year2	Year3	Year4
Assets				
Cash in checking	$ 769,719	$ 353,355	$ 531,455	$ 761,336
Cash in Savings	-0-	-0-	-0-	-0-
Accounts Receivable	7,100	1,408	116,779	450,773
Notes/Loan Receivable	-0-	700,000	5,700,000	5,700,000
Prepaid Expenses	-0-	-0-	9,000	9,000
Investments in Bonds	1,000,000	-0-	-0-	-0-
Due From Parent	12,351	-0-	-0-	-0-
Investment in Partnership	21,772,352	21,580,655	21,611,901	21,743,162
Total Assets	$23,561,522	$22,660,418	$27,969,135	$27,969,135
Liabilities				
Premiums Held on Deposit	1,065,227	40,562	40,562	40,562
Losses and Loss Adj. Exp.	170,532	45,000	45,000	45,000
Unearned Premium Reserve	-0-	-0-	-0-	-0-
Income Tax Payable to Parent	41,254	46,984	-0-	-0-
Other Liabilities	24,500	34,000	36,000	32,500
Total Liabilities	$ 1,301,513	$ 166,546	$ 121,562	$ 118,062

Net Worth				
Capital Stock	100,000	100,000	100,000	100,000
Paid in Capital	21,981,868	21,762,825	26,768,142	26,880,408
Retained Earnings	178,141	606,047	979,431	1,565,801
Total Fund Balance	22,260,009	22,468,872	27,847,573	28,546,209
Total Liab. & Net Worth	$ 23,561,522	$ 22,635,418	$27,969,135	$ 28,664,271

C. A's Form 990

A filed a Return of an Organization Exempt from Income Tax (Form 990) for the taxable years Year1 through Year4. A also filed Exempt Organization Business Income Tax Return (Form 990-T) for taxable years Year2 through Year4. A did not file Form 990-T for taxable year Year1. Prior to Year1, A filed Form 1120 returns for 1998 and 1999. On its Forms 990, A reported premium income of $53,174, $340,238, $300,000, $300,000 in Year1, Year2, Year3 and Year4, respectively, related to its I.R.C. § 501(c)(15) tax-exempt status.

As a result of its tax-exempt status, net income from passive sources totaling $101,340 in Year1; ($391,981) in Year2; ($517,218) for Year3; and $14,799 was not subject to income tax pursuant to I.R.C. § 512(b)(1) and/or I.R.C. § 501(a).

A reported its share of partnership losses of ($460,016), ($641,511) and ($326,329) as unrelated business income on its Form 990-T returns for taxable years Year2, Year3, and Year4, respectively. A did not pay unrelated trade or business income tax for years Year2, Year3, and Year4.

D. Organization:

A ("A") is wholly owned by B. B and its sister entity, C are subsidiaries of D. C is the parent of E. A was formed in Prior Year 2, as a pure captive in the City of Location 1.

As a domestic entity, A was not required to file an election under I.R.C. 953(d) with the Internal Revenue Service.

In its business plan, the organizational structure of A is described as follows:

> B is forming a captive to provide a more formalized insurance program for E, its owned and managed locations.
>
> E is one of the
>
> in the United States. It manages hotels that it owns as well as hotels that are owned by unrelated parties. The management contract between the hotels and E specifies that the owners are responsible to reimburse E for the costs of the insurance program related to their hotel. The costs include claims, the purchase of insurance, administrative costs, safety, and other related costs.
>
> Although each location will be transferring a significant risk to the captive, there is very little risk of aggregate losses to the captive because of the insurance structure. A is expected to make a steady annual profit.
>
> A will be 100% owned by B.A will insure E and its affiliates.

A had less than $350,000 in net premiums per year, and therefore, qualified as a tax-exempt insurance company pursuant to I.R.C. § 501(c)(15). A Determinations Letter was issued to A, by the IRS, on May 14, Year2, granting A tax-exempt status under I.R.C. § 501(c)(15).

E. Implementation of the Insurance Strategy

In Prior Year 1, F a firm hired by A, filed a business plan for A with the State of State 1, Department of Banking and Insurance. The business plan included the following description of A's insurance operations:

> During its initial years of operation, A will insure the risks listed below. This risk

arises from the exposures of C, its entities, as well as managed hotels. E manages hotels under a variety of names: C's, C1, and other franchise names. Initially, A will insure these risks:

- Contractual Liability
- Auto Physical Damage
- Garage Keepers' Legal Liability
- Crime
- Contractual Liability Policy for Workers' Compensation Premiums

E is contractually obligated to pay a premium to G for their workers' compensation coverage. At 18 months, G will calculate the final premium and/or dividend and Eis responsible for paying any amounts due or will receive a dividend.

E will collect premiums from its locations equal to 1/12 of the standard premium each month. For the first 9 months, it will remit the premiums to G. For the last 3 months, the premium will be remitted to A for a contractual liability policy. A will be contractually responsible to pay any additional premiums due to G and will be entitled to any returns.

Since A will collect the maximum additional premium due to G (about $985,000), A cannot have an underwriting loss. IF the amount of return premiums calculated at 18 months is less than $985,000, A will pay the difference and it will be shown as a loss. If the return premium is greater than $985,000, the additional return will be paid to A and will be shown as additional premium income.

A discontinued the above lines of insurance as of Year 1. An amended business plan was filed with the State of State 1, Department of Banking and Insurance, on April 4, Year 2. Under the amended business plan, A indicated that it desired to write a

Representations and Warranties policy. The transition was described in the amended business plan as follows:

> Need for a Representations and Warranties Policy arose when H completed a corporate transaction whereby H agreed to transfer certain third party management contracts, of certain unrelated hotel properties, to a newly created U.S. company, S, in exchange for a 15% interest in
>
> . Perhaps the most significant exposure in this transaction is what is referred to as the "W." Coverage for this exposure as well as taxes and claims asserted by employees under the terms of the agreement would be difficult to purchase on the market as further explained in the attached Business Plan.
>
> The policy is to be issued by A to S,Ltd., the insured, and to T,Ltd. and S, Inc. as additional insureds. The ultimate parent of A and the insureds is T, Ltd. A's limit of liability is $5,000,000. The total premium for the six year policy is $750,000.

A offered only the Representations and Warranties Policy during years Year2, Year3, and Year4.

F. Capital Structure of A

The State 1 captive statute provides minimum capitalization requirements for various types of captives. The minimum statutory capitalization for a single-parent State 1 captive is $250,000 in cash or letter of credit.

At formation, on Date 1, A was authorized to issue 200,000 shares of stock with a $1 par value. On Date 2, B acquired 100,000 shares of A's common stock for a cash contribution of $100,000. The shareholder, B, also contributed additional surplus cash of $150,000.

No other capital was contributed by the sole shareholder until Year 1, when B contributed 99% interests in three limited liability partnerships to A, reported at their net equity value of $22,172,352.

The capital contribution was made to A to cover the potential risk exposure related to the Representations and Warranties policy written for an affiliate, S, Inc., in Year2.

The amended business plan referenced the $22.7 million capital contribution received by A from its affiliates.[1] A received partnership interests in Partnership 1 ($3,167,774), Partnership 2 ($9,498,499), and U, Ltd. ($9,506,079). The business plan indicates, "in the event of a catastrophic claim, A may secure a mortgage loan on the hotel properties to pay the claim."

In the Date 3 response to Information Document Request #2, POA 1, CPA with Representative 1, explained the need for the additional capital as follows:

> A has accumulated assets in excess of $23 million, as of Year 1, because of the potential loss exposure on the insurance programs written and the capital requirements of the State of State 1. Additionally, the investments held by A were illiquid resulting in a need to ensure that there was a sufficient capital base to pay potential claims in the event certain assets could not be liquidated or pledged to satisfy claims.

B, the sole shareholder, contributed an additional $5,000,000 in cash to A in Year3.

G. <u>Employees and Officers of A</u>

A had no employees during years Year1, Year2, Year3, and Year4. A did not pay a salary to its officers for Year1, Year2,

* * * *

[1] According to Statement 2, attached to the Year3 Form 990, the value of the partnership interests was adjusted to $21,768,142, an increase of $5,317.

Year3, and Year4, as reflected on A's Forms 990 for each of the years. Instead, A's officers were paid as employees of B

F provided insurance management services for A, including interfacing with the insurance regulators in the State of State 1 and the handling of management and administrative services related to A's insurance operations. A executed a management contract with F on Date 1.

H. A's Insurance Activity for Year1

In Year1, A provided insurance policies to third party hotels for which A's sister corporation, E. and affiliates, had negotiated contracts to serve as the hotels management. As such, E. was compensated for providing such services as accounting, reservations, customer services, and insurance.

With respect to insurance, A wrote 42 deductible reimbursement policies for property, crime, auto physical damage and employment practices liability insurance. A review of the policy Declaration pages revealed that E. is listed as the "NAMED INSURED" for all policies written by A in Year 1. In its June 28, 2005 response to IDR #3, Question 1, Representative 1 provided the following explanation about why E. is listed as the NAMED INSURED, as oppose to the hotels managed by E.

> The Managed hotels are not named as insured. The policies only respond based upon claims submitted by C. Claims by Ewould arise from the indemnity agreed upon in the management contracts but the managed properties did not have rights to the coverage. They had rights only against C.

In Year1, A wrote the following deductible reimbursement insurance policies:

	No.	Per Annual Occurrence/Aggregate
EPLI 1003A - 1003U	21	$20,000 and $150,000
Crime AU1003A - U1003N	14	$10,000 and $ 60,000
Auto Damage AU1004A - AU1004G	7	$100,000 and $200,000
Total number policies	42	

The garagekeepers' legal liability insurance, which was offered in 1999, was not offered by A in Year1.

Clause B of the policies describes the "limit of liability," and indicates the most A will pay for "losses" under the policies is the amount shown as A's Limit of Liability in the Declarations. Based on the terms of the above policies, A's maximum limit of liability, in Year 1, for 21 EPLI policies is $3,150,000; for 14 Crime policies is $840,000; and for 7 Auto Physical Damage policies is $1,400,000; or a combined maximum limit of liability totaling $5,390,000.

On August 17, Year1, A received check number 055335 from E., in the amount of $170,000, for the purchase of the following deductible reimbursement insurance policies:

EPLI	$ 60,000
Crime	60,000
Auto Physical Damage	50,000
Total	$ 170,000

However, on the Year1 Form 990, A recognized only part of the above premiums as income for the year. On its Form 990 for Year1, A recognized gross premiums related to the insurance policies of $53,174. A recognized gross premium income on the Year1 Form 990 as follows:

Employment Practices Liability	$19,437.74
Crime	19,761.87
Auto Physical Damage	13,974.47
Gross Premium Income	$53,174.08

The balance of the premiums not recognized as income for Year 1, of $116,826, was reported as a liability called "premiums held on deposit."[2] As of Year 1, A reported total "premiums held on deposit" of $1,065,227. The liability amount appears to be slightly understated. Based on the information provided by REPRESENTATIVE 1, the correct "premiums held on deposit" should be $1,101,248. The amount consisted of the unearned premiums of $116,826 remaining from the premium check and premiums of

* * * *

[2] The "premiums held on deposit" attributable to the deductible reimbursement policies are as follows: EPLI $40.562.26; Crime $40,238.13; and Auto $36,025.54

$984,422 received in December 1998 from a workers' compensation policy sold to its affiliate, E. According to Note 6 of the Year1 REPRESENTATIVE 1 Financial Statement, the policies include "adjustable premium features" that result in the policies not transferring insurance risk from E. to A. Like the workers' compensation policy, the premiums related to the Crime, Auto, and EPLI policies were recorded as "premiums held on deposit" because the policies do not transfer risk to A.

Since Year 1, approximately 95% of A's premiums are derived from policies that do not transfer risk from the insured, E and managed hotels, to A, the insurer (See Exhibit 3). In the notes to the Year1 REPRESENTATIVE 1 financial statement, it is clearly acknowledged that the 1998 worker's compensation policy and the Year1 Crime, Auto, and EPLI policies with E. do not transfer risk to A, and thus, the premiums from these policies are reported on its books as "premiums held on deposit."

In Year1, A paid claims to E. of $19,955, $26,489 and $21,575 under the auto physical damage, crime, and property deductible reimbursement insurance policies, respectively.

A discontinued the property, crime, auto physical damage and employment practice liability coverage at the end of Year1. The remaining reserves from the prior business were maintained on A's books and the lines of business were in run-off. As a result of a corporate reorganization, E. transferred its interest in the hotel management contracts to S, Inc. E. and its affiliates agreed to indemnify S, Inc. and its affiliates against certain pre-closing liabilities and representations and warranties. In Year2, A sold a Representations and Warranties policy to an affiliate, ., a domestic company. S, Inc. paid a total premium of $750,000 for the six-year policy. A's limit of liability is $5,000,000.

Year2 - Year4

A amended its business plan in April Year 2. A notified the Department of Banking and Insurance in the State of State 1, of the H reorganization; its decision to discontinue the crime, auto physical damage, and employment practices liability insurance; and its decision to provide Representations and Warranties coverage to an affiliate, S, Inc.

On June 15, Year1, a Contribution Agreement was executed by E., a State 2 corporation; D1, a Location 2 company; and H, a Location 3 company, whereby the parties agreed to form a new corporation in Location 4 called "S Ltd"[3] In exchange for a 15% ownership interest in S Ltd, H transferred the third party management contracts of E. and certain other assets to S, Inc., a wholly owned affiliate of S Ltd. The remaining 85% of S Ltd is owned by T, a Location 2 company, in which H also owns a 52.4 interest.

After the reorganization, H, a publicly traded Location 3 corporation, owned 100% of several corporations, including E and B H also continued to own 100% of A, through its ownership in S, Ltd and its affiliate, S, Inc. assumed the responsibility of providing insurance coverage for the managed hotels.

E agreed to insure S Ltd and its affiliates against potential claims arising from the pre-closing liabilities and representations and warranties, utilizing A, to provide the insurance for the year Year 2. A continued to offer the representations and warranties coverage to S Ltd and its affiliates for up to six years.

The most significant exposure resulting from the reorganization is "W." The amended business plan described the potential "W" as follows:

> In a recent state court case (currently on appeal), a manager of Hotel properties was found to be liable to the owners of a hotel property for failing to forward the benefits of certain rebate and discount programs to the owners of the hotel. Although it is difficult to quantify the potential liability for such claims, the potential exposure due to W may be significant. Although H and its affiliates are not a party to the
>
> case, management believes that if this precedent is applied to the management contracts which have been

* * * *

[3] The June 15, Year1 Contribution Agreement was amended on June 23, Year1 and Year 1. The above details were obtained from POA 1, CPA, in his response to Question 10 of IDR #2.

transferred to , significant legal costs could be incurred.

Section 6.4 of the Contribution Agreement limits the amount of the exposure to $5 million, not withstanding any other provisions in the Agreement. Further, Section 6.7 of the Contribution Agreement provides the H may satisfy its obligations by providing an insurance policy for the benefit of . has requested that such a policy be provided.

E. hired an independent consultant, Consultant 1 and risk management firm, Firm 1, who concluded that the representations and warranties policy, as requested by S, Inc., would be difficult, if not impossible, to obtain in the commercial market because the potential exposure is so broad and difficult to quantify. In the opinion of the consultants, commercial insurers will not write such a policy. Based on this advice, H and its affiliates determined that it would be more cost effective if the representations and warranties policy was written by A.

The initial Representations and Warranties policy was written on January 1, Year2. S, Inc. paid a total premium of $750,000 for the six-year policy. A's limit of liability is $5,000,000. Based on the recommendation of the consultants, the policy was priced at 15% of the $5 million exposure limit. Annual policies would be issued for the six year period, requiring S, Inc. to pay policy premiums as follows:

Policy Year	Premiums
Policy Year 1	$300,000
Policy Year 2	$300,000
Policy Year 3	37,500
Policy Year 4	37,500
Policy Year 5	37,500
Policy Year 6	37,500
Total	$750,000

No other lines of business were offered by A in Year2, Year3, and Year4.

A received capital contributions consisting of the 99% interests in three partnerships, valued at approximately $22.7 million to meet its potential risk under the representations and warranties policy. The amended business plan, page 8, included the following description regarding the partnership contributions:

> In order to provide adequate capitalization to support A's $5 million exposure, additional capital has been contributed to A. Due to illiquidity, assets in excess of $5 million were contributed to the Company. These assets may need to be pledged as security for a loan, or liquidated to pay claims.
>
> Under the terms of the R&W policy, A will have up to 120 days to pay any claims that are submitted. In the event of catastrophic claim, A may secure a mortgage loan on the hotel properties to pay the claim.

For years Year 1, and Year4, A reported premium income consistent with the schedule of policy premiums. In Year2, A also recognized additional premiums of $40,238 from amounts previously recorded on the books as "premiums held on deposit." A incurred claims of $11,500 under the crime and property deductible reimbursement policies in Year2. No claims were incurred under the prior lines of business for Year3 and Year4. In addition, A did not incur any claims under the Representations and Warranties policy sold to S, Inc. during years Year 1, and Year4, nor did A set aside reserves for potential future losses. No other insurance business was conducted by A.

I. Application for 501(c)(15) Exemption

In January Year2, A sent the IRS in Covington, Kentucky, a Form 1024, Application for Recognition of Exemption under section 501(a) (with Form 2848 and 8821 attached). Attached to the Form 1024 application was A's Articles of Incorporation (2 pages), a Certificate of General Good and a Certificate of Authority from the State of State 1 (1 page each), an Application To Reserve Name (1 page), Stock Certificate and related letter (3 pages), a description of current and future programs (1 page), an

Organizational chart (2 pages), a Contribution Agreement, dated June 15, Year1 (22 pages), the First Amendment to Contribution Agreement, dated September 29, Year1 (5 pages), the Second Amendment to Contribution Agreement (4 pages), Sample of Deductible Reimbursement Policy Crime Insurance for Year1(4 pages), Sample of Deductible Reimbursement Policy Employment Practices Liability Insurance for Year1 (4 pages), Sample of Deductible Reimbursement Policy Automobile Physical Damage Insurance for Year1 (4 pages), a copy of Representations and Warranties Policy for Year2 (13 pages),and a list of Supplement Questions and Answers to Form 1024 (2 pages). Also submitted with the application was a Form 8718, User Fee for Exempt Organization Determination Letter Request (1 page) and Form 2848, Power of Attorney (2 pages).

In February Year2, the application was referred to the Assistant Commissioner, Internal Revenue Service, 1111 Constitution Ave., Washington, D.C.

In a letter dated March 12, Year2, the Service requested additional information from A (2 pages).

, with REPRENSATIVE 1 1, responded to the Service's request for additional information on April 11, Year2. The response included a coverletter with answers to specific questions (4 pages), a chart showing insurance policies written by A in Year1, (1 page), list of policies written for managed hotels in Year1 (1 page), an ownership schematic (1 page), a copy of the Representations and Warranties policy for Year2 (12 pages), the Year1 (24 pages), and a copy of the Financial Statement as of March 31, Year2 (3 pages).

On May 14, Year2, the Service issued A a determination letter granting A exempt status as an I.R.C. § 501(c)(15) organization (2 pages). These documents, which were exchanged by the parties during the application process, comprise the administrative record and formed the basis for the determination.

Aside from the documents identified in the above paragraphs, no other documents were exchanged during the exemption application process.

The Form 1024 Application provided actual financial information for the tax years Date 1, through December 31, 1998, January 1, 1999, through December 31, 1999, and January 1, Year1,

through Year 1. No proposed budgets were included with the application. A was not tax-exempt for 1998 and 1999. The application showed A received insurance premiums of $53,174 in Year1. A also reported receiving investment income of $101,340 in Year1. No other revenue was reported in Year1. The Form 1024 application reported total assets of $23,561,522 as of Year 1. Assets included "other assets" of $21,772,352. A schedule attached to the application revealed that "other assets" represented investments in , and

.

A filed Form 990 for Year1 and Forms 990 and 990-T for the years Year2, Year3, and Year4. A did not report any changes in operation on Form 990 filed with the Internal Revenue Service for the years Year1, Year2, Year3, and Year4.

A did not submit additional documents or otherwise provide notice to the Internal Revenue Service of any changes in operations subsequent to the issuance of the May 14, Year2 exemption letter.

III. LAW AND ANALYSIS:

A. Is A an Insurance Company Exempt From Tax Pursuant to I.R.C. § 501(c)(15) for the Taxable Years Year1, Year2, Year3, and Year4?

The first issue is whether A is an insurance company exempt from tax pursuant to I.R.C. §501(c)(15) for the taxable years Year1, Year2, Year3, and Year4. I.R.C. § 501(a) provides that certain entities are exempt from taxation. Included in these entities are "[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." I.R.C. § 501(c)(15)(A).

If an entity is a part of a consolidated group, all net written premiums (or direct written premiums) of the members of the group are aggregated to determine whether the insurance company meets the requirements of I.R.C. § 501(c)(15)(A). I.R.C. § 501(c)(15)(B). Here, A was part of an affiliated group during

Year1, Year2, Year3, and Year4. A is wholly owned by B, which in turn, is wholly owned by D1. However, none of the other affiliates engaged in insurance operations during years Year1, Year2, Year3, and Year4. Therefore, the total premiums attributable to the controlled group are earned only by A --- $53,174 for Year1; $340,238 for Year2; $300,000 for Year3; and $300,000 for Year4. There are no other premiums to aggregate with the premiums A received during Year1, Year2, Year3, and Year4, pursuant to I.R.C. § 501(c)(15)(B).

For the years involved, an insurance company for federal income tax purposes is a company whose primary and predominant business activity during the year was the issuing of insurance or annuity contracts or the reinsuring of risks underwritten by insurance companies. See Treas. Reg. § 1.801-3(a)(1). See also I.R.C. § 816(a) (company treated as an insurance company for purposes of definition of a life insurance company only if more than half of the business of that company is the issuing of insurance or annuity contracts or the reinsuring of risks underwritten by insurance companies).

Neither the Code nor the regulations define the terms insurance or insurance contract. The United States Supreme Court, however, has explained that for an arrangement to constitute insurance for Federal income tax purposes, both risk shifting and risk distribution must be present. Helvering v. LeGierse, 312 U.S. 531 (1941). The risk shifted and distributed must be an insurance risk. See, e.g., Allied Fidelity Corp. v. Commissioner, 572 F.2d 1190 (7th Cir. 1978), cert. denied, 439 U.S. 835 (1978); Rev. Rul. 89-96, 1989-2 C.B. 114.

Risk shifting occurs if a person facing the possibility of an economic loss resulting from the occurrence of an insurance risk transfers some or all of the financial consequences of the potential loss to the insurer. The effect of such a transfer is that a loss by the insured will not affect the insured because the loss is offset by the insurance payment.

Risk distribution incorporates the "law of large numbers" to allow the insurer to reduce the possibility that a single costly claim will exceed the amount available to the insurer for the payment of such a claim. 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).

Section 1.801-3(a) of the regulations defines the term "insurance company" to mean a company whose primary and predominant business activity during the taxable year is the issuance of insurance or annuity contracts or the reinsurance of insurance 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 also Inter-American Life Ins. Co. v. Commissioner, 56 T.C. 497, 506-08 (1971), aff'd per curiam, 469 F.2d 697 (9th Cir. 1972) (taxpayer whose predominant source of income was from investments did not qualify as an insurance company); Bowers v. Lawyers Mortgage Co., 285 U.S. 182, 188 (1932).

To qualify as an insurance company, a taxpayer must use its capital and efforts primarily in earning income from the issuance of contracts of insurance. Indus. Life Ins. Co. v. United States, 344 F. Supp. 870, 877 (D. S.C. 1972), aff'd per curiam, 481 F.2d 609 (4th Cir. 1973). All of the relevant facts will be considered, including but not limited to, the size and activities of any staff, whether the company engages in other trades or businesses, and its sources of income. See generally United States v. Home Title Ins. Co., 285 U.S. 191, 195 (1932) (where insurance and charges incident thereto were more than 75% of company's income, "[u]ndeniably insurance [was] its principal business."); Lawyers Mortgage Co. at 188-90; Indus. Life Ins. Co., at 875-77; Cardinal Life Ins. Co. v. United States, 300 F. Supp. 387, 391-92 (N.D. Tex. 1969), rev'd on other grounds, 425 F. 2d 1328 (5th Cir. 1970); Serv. Life Ins. 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 Ins. Co., at 506-08 ; Nat'l. Capital Ins. Co. of the Dist. of Columbia v. Commissioner, 28 B.T.A. 1079, 1085-86 (1933). However, a company engaged solely in reinsurance may have a very sparse operation. See Alinco Life Ins. Co. v. United States, 178 Ct. Cl. 813, 837-38 (1967)(that reinsurance company had extremely simple operation with very little general operating expense did not preclude conclusion that it was a life insurance company under section 801 of the Code).

In Bowers v. Lawyers Mortgage Co., 285 U.S. 182 (1932), the Supreme Court determined that the taxpayer was primarily engaged in "the lending of money on real-estate security, the sale of bonds and mortgages given by borrowers and use of the money received from purchasers to make additional loans similarly secured." Bowers, 285 U.S. at 188-89. Although the taxpayer in Bowers earned "premiums" that amounted to approximately one-third of its income for the taxable years at issue, these premiums were attributable to the excess of the interest paid to the taxpayer by borrowers over the amount the taxpayer paid the purchasers to whom it subsequently sold bonds and mortgages. Id. at 188 n.5. The premiums also included fees the taxpayer charged for guaranteeing mortgage loans which it did not make or sell. Id. at 186. The Court noted that the "premiums" the taxpayer earned included agency and other services provided by the taxpayer which were not generally provided under traditional insurance contracts. Id. at 189.

Because the taxpayer's premium income was incidental to its business of lending money, the Bowers Court held that the taxpayer was not an insurance company for tax purposes. Id. at 190. The Court explained, "[t]he lending fees, extension fees and accrued interest appertain to the business of lending money rather than to insurance, and may not reasonably be attributed to the subordinate element of guaranty in [taxpayer's] mortgage loan business." Id. at 189. Cf. United States v. Home Title Insurance Co., 285 U.S. 191 (1932) (holding that taxpayer was an insurance company where taxpayer derived over 75% of its income from the insurance of titles and guarantees of mortgages).

In Inter-American Life Ins. Co. v. Commissioner, 56 T.C. 497 (1971), aff'd per curiam, 469 F.2d 697 (9th Cir. 1972), the taxpayer issued and reinsured 17, 280, 325, and 424 insurance policies earning premiums totaling $867.94, $1,554.76, $1,125.70, and $1,421.98 during the taxable years 1958, 1959, 1960, and 1961, respectively. Inter-American, 56 T.C. at 507. Virtually all of the reinsurance contracts issued by the taxpayer came from another insurance company which was owned by the same two shareholders as the taxpayer. Id. Similarly, almost all of the directly written insurance policies issued by the taxpayer were issued to the same two shareholders of the taxpayer. Id. The taxpayer also engaged in the sale of real property and stock, earning investment income totaling $35,988.21, $31,195.60, $36,436.04, and $33,815.44 over the four years at issue. Id.

In Inter-American, the Tax Court compared the taxpayer's income from its insurance-related activities to its income from other activities, and held that the taxpayer was not an insurance company. According to the Tax Court, the insurance premiums the taxpayer earned were *de minimis*, comprising less than 15% of the taxpayer's gross investment income. Id. In addition, the taxpayer had no sales force in place to sell insurance contracts. Id. 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. Id. at 508.

The Tax Court also acknowledged that it was cognizant of the "problems indigenous to new life insurance companies, in particular, that the initial years of a new life insurance company's operations are generally difficult because the initial expenses incurred in 'putting policies on the books' are greater than the premiums received" Id. (citing S. Rept. No. 291, 86th Cong., 1st Sess. (1959), 1959-2 C.B. 779). The Court explained, however, that it was basing its decision on the fact that the taxpayer did not focus its "capital and efforts primarily" on its insurance business, not on the fact that the taxpayer's insurance business was not profitable. Id. (citing Cardinal Life Ins. Co. v. United States, 300 F. Supp. 387 (N.D. Tex. 1969).

In Cardinal Life Ins. Co. v. United States, 300 F. Supp. 387 (N.D. Tex. 1969), rev'd on other grounds, 425 F.2d 1328 (5th Cir. 1970), the taxpayer earned no income from insurance in two of the five years under examination, and earned .66%, .87% and 9.11% of its total income from insurance during the remaining three taxable years at issue. Cardinal Life, 300 F. Supp. at 389. Instead, the taxpayer earned a majority of its income from dividends, interest, rent and capital gains. Id. Like Inter-American, the taxpayer in Cardinal Life failed to employ any brokers, solicitors, agents or salesmen. Id. It did, however, pay an actuary on a fee basis to determine the amounts of its premiums. Id. The Court noted that the taxpayer's income from insurance policies was "insignificant" compared to the total income earned by the taxpayer, explaining,

> While Plaintiff's insurance activities were insignificant, it was generating substantial income from dividends on stocks, rental income on real estate, rental income on

> trailers, interest income and capital gains upon disposal of real estate and stocks. These types of income constitute … personal holding company income which Congress has specifically stated is subject to a tax in addition to ordinary income tax. The Plaintiff is seeking to remove itself from the grasp of the personal holding company provisions by claiming life insurance company status through the issuance of a small and insignificant amount of insurance contracts.

Id. at 382.

In Industrial Life Ins. Co. v. United States, 344 F. Supp. 870 (D.S.C. 1972), aff'd per curiam, 481 F.2d 609 (4th Cir. 1973), the Fourth Circuit rejected the taxpayer's claim that it was an insurance company where the taxpayer earned 20% of its income from selling credit life insurance and issuing life insurance policies to its officers, and the balance of its income from its investment portfolio and the sale and leasing of real estate. The court explained,

> It is obvious from the financial information . . . that the premium income for these years was small when compared with income from real estate, mortgages and investment.
>
> It is also important to note that more than half of the premium income came from policies on the lives of the only officers and stockholders of the company.

Id. at 876. The Court likened the facts of Industrial Life to those of Cardinal Life. Id.

By contrast, in Service Life Ins. Co. v. United States, 189 F. Supp. 282 (D. Neb. 1960), aff'd on other grounds, 293 F.2d 78 (8th Cir. 1961), the Court held that the taxpayer was an insurance company where it had "over $22,000,000 worth of life insurance on its books; over 70,000 individual policies in force; and approximately $1,675,000 in premium income" over a four year period. Id. at 286. The Service Life Court acknowledged that whether a company is considered an insurance company turns on the

character of the business conducted by the company, not any percentage of income. Id. at 285-86. The Court did, however, compare the taxpayer's premium income to its investment income to determine the business activity of the taxpayer. Id. at 286. Although the taxpayer also generated income from mortgage loans and investments, over half of the taxpayer's income was from its insurance premiums, and over half of its income-producing assets were held for insurance policy reserves. Id.

No single factor determines whether a company's primary and predominant business activity for a taxable year was the issuing of insurance or annuity contracts or the reinsuring of risks underwritten by insurance companies. Thus, in some cases, a start-up company (or a company winding down operations) may qualify as an insurance company even if premiums represent less than half the receipts of the company provided the company's capital and efforts are devoted primarily to its insurance business.

i. Workers' Compensation Insurance

During years prior year 1 and prior year 2, A was obligated under a contracted liability policy for workers' compensation issued in 1997, to an affiliate, E. E. paid a premium of $984,427 to A. The policy did not transfer risk from Eto A and, as such, the premium received by A was recorded as a liability --- "premiums held on deposit." Under the terms of the contract, the maximum coverage provided by the policy was equal to the premium paid in. To the extent losses were less than the premiums, A is obligated to refund the excess amount to C. As of Year 1, no losses were incurred under the policy and A refunded the amount previously recorded as a liability "premiums held on deposit" to E. in Year2.

ii. Deductible Reimbursement Policies

Based on the review of the activities conducted by A during the period of January 1, Year1, through December 31, Year 1, it was determined that A wrote 7 auto physical damage, 14 crime, and 21 employment practices liability policies. The policies were sold to hotels managed by an affiliate, E., although the Declaration for each policy list E Service, Inc. as the insured.

During Year1, A reported two sources of premiums related to the deductible reimbursement auto, crime, and employment

practices liability policies. A recognized premiums of $53,174 in Year1. The premiums were received from unrelated hotels managed by A's affiliate, E Services. The premiums paid to A by the 42 managed hotels do include the characteristics of risk shifting and risk distribution, and thus, represent premiums from insurance operations with the meaning of Helvering v. LeGierse, 312 U.S. 531, 539 (1941).

However, A also reported additional premiums that were recorded as a liability called "premiums held on deposit" in the amount of $1,065,227. The "premiums held on deposit" consisted of the premiums received from the 1997 workers' compensation policy with E Services, ($984,427) and "premiums held on deposit" of $80,800 for Crime, Auto Physical Damage and Employment Practices Liability policies written for E. in Year1.

The premiums held on deposit were received from policies that do not transfer risk from the insured to A. The following description of the "premiums held on deposit" is included in Note 6 of the Year1 Financial Statement, prepared by REPRESENTATIVE 1,

> the policies include "adjustable premium features" that result in the policies not transferring insurance risk from E. to A. Like the workers' compensation policy, the premiums related to the Crime, Auto, and EPLI policies were recorded as premiums held on deposit because the policies do not transfer risk to A.

A discontinued the crime, auto physical damage and employment practice liability coverage at the end of Year1.

As of Year 1, approximately 95% of A's premiums are derived from policies that do not transfer risk from the insured, E and managed hotels to A, the insurer. In the notes to the Year1 financial statement, prepared by REPRESENTATIVE 1, it is clearly acknowledged that the 1997 worker's compensation policy and the Year1 Crime, Auto, and EPLI deductible reimbursement policies with E. do not transfer risk to A, and thus, the premiums from these policies are reported on its books as "premiums held on deposit."

Based on the above facts, it is determined that A's primary and predominant activity in Year1 is not insurance because the

majority of the contracts executed with E Service, Inc. are not insurance contracts. For an arrangement to constitute insurance the characteristics of risk shifting and risk distribution must be present. Absent either risk shifting or risk distribution, such arrangement is not insurance. Since 95% of the premiums received by A are derived from policies that do not result in risk shifting, A's capital and efforts are not used for the purpose of insurance. Thus, A is not primarily and predominantly operated for an insurance business in year Year1.

iii. Representations and Warranties Policy

In Year2, A sold a Representations and Warranties policy to an affiliate, . The Representations and Warranties policy is the sole line of business offered by A during years Year2, Year3, and Year4. The policy is a six year policy and requires . to pay premiums to A totaling $750,000 over the six year term. A's maximum liability under the policy is $5,000,000.

One treatise on insurance in explaining risk distribution states that, "[w]hen insurance is considered from the viewpoint of an insurer … it is appropriately viewed as a system for risk distribution as well as risk transference. Insurers deal with the uncertainty of whether a given insured will sustain a loss by combining the risks of loss for many ventures of a given type into a pool." Keeton and Widiss, Insurance Law, A Guide to Fundamental Principles, Legal Doctrines, and Commercial Practices, p. 12, West Group (1988).

The Courts have not spent a great deal of time explaining what they mean by risk distribution. No court has squarely held that there can be no risk distribution if there is only one, or a few, insureds. A fair reading of the court opinions addressing the issue, however, supports the IRS's position. See Barnes v. United States, 801 F.2d 984, 985 (7th Cir. 1986)("Risk distributing is the spreading of the risk of loss among the participants in an insurance program."). See also, Commissioner v. Treganowan, 183 F. 2d 288, 291 (2d Cir. 1950). Such spreading is effectuated by pooling among unrelated insureds. "…[R]isk distribution means that the party assuming the risk distributes his potential liability, in part, among others." Beech Aircraft Corp. v. United States, 797 F.2d F.2d 920, 922 (10th Cir. 1986).

Risk distribution is accomplished where the risk is distributed among insureds other than the entity that incurred the loss. See Ross v. Odom, 401 F. 2d 464 (5th Cir. 1968).

The Sixth Circuit touched on the issue of risk distribution in Humana, Inc. v. Commissioner, 881 F.2d 247, 257 (6th Cir. 1989), noting there was adequate risk distribution, "where the captive insures several separate corporations within an affiliated group and losses can be spread among the several distinct corporate entities." The Ninth Circuit has also measured risk distribution by explaining, "[i]nsuring many independent risks in return for numerous premiums serves to distribute risk. 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. Commissioner, 811 F.2d 1297, 1300 (9th Cir. 1987).

There cannot be risk distribution when there is only one insured. During Year2 through Year4, A failed to adequately distribute the risks associated with its Representations and Warranties policy. A sold a single policy to S, Inc. during the years Year2, Year3, and Year4. No other lines of insurance were offered by A. In fact, the deductible reimbursement policies were in "run-off" as of Year 1. In addition, S, Inc. is affiliated with A through a common parent, H, which indirectly owns 100% of A and 15% of S, Ltd. and its affiliate, S, Inc. A did not maintain "numerous" or "several" independent risks in exchange for "numerous" premiums, compared to the taxpayers in Humana and Clougherty. Insuring a single Representations and Warranties policy at any given time does not qualify as adequate risk distribution.

Therefore, we concluded that the Workers' Compensation policy sold to E., in 1997, and the deductible reimbursement policies sold to E, and its managed hotels, in Year1, do not constitute insurance contracts because the arrangements lack the characteristic of risk shifting. We also determined that the Representations and Warranties policy sold by A to S, Inc. does not constitute an insurance contract because the arrangement lacks the characteristic of risk distribution. As such, A's primary and predominant activity during years Year1, Year2, Year3, and Year4 is not insurance.

A is not operated as an insurance company within the meaning of Treasury Regulations Section 1.801-3(a)(1). Because A is not an insurance company, it fails to qualify for exemption under Section 501(c)(15) of the Internal Revenue Code.

A does not qualify as an insurance company because its primary and predominant activity is not insurance. In order to qualify as an insurance company, A's capital and efforts must be used primarily to generate income from the issuance of insurance or reinsurance contracts. As stated in Treas. Reg. §1.801-3(a)(1), in determining the primary and predominant activity, the Service must look to the character of business actually done during the taxable year, as opposed to the activities, which are authorized. Based on the facts presented during the audit, A does not have facilities or staff engaged in the selling of insurance policies. An outside management company, F, (State 1) conducts risk management and administrative services on behalf of A. A does not promote, market, advertise or solicit insurance business from the general public. The absence of an active sales staff is one factor considered by the Courts to conclude that the company's primary and predominant activity is not insurance. In both Cardinal Life and Inter-American Life, where the courts determined that the primary and predominant business of each company was not insurance, neither company employed a sales force. In Cardinal Life, although the taxpayer sold some reinsurance contracts during the years at issue, the District Court noted,

> Plaintiff did not have an active sales force soliciting or selling insurance policies. Each of the insurance policies actually written by Plaintiff was as the result of reinsurance agreements wherein other companies ceded to Plaintiff certain amounts of insurance written by them. These reinsurance contracts were negotiated either by the president and sole stockholder of Plaintiff and/or the company's actuary who rendered services to Plaintiff on a fee basis. Plaintiff otherwise did not have any employees, brokers, agents or salesmen soliciting and selling insurance for it, and the only insurance written by Plaintiff was through reinsurance agreements.

The facts in the present case are similar to the position expressed by the District Court in **Cardinal Life.** Key employees of the sole shareholder, B , and its parent, H, negotiated the insurance policies, on behalf of A, with E. and its managed hotels in Year1. They also negotiated the Representations and Warranties policy with S, Inc. which was A's sole line of business in years Year2, Year3 and Year4. Because A does not have facilities or employ staff that is directly and actively engaged in insurance or reinsurance underwriting services, we conclude the does not have the traditional characteristics of an insurance business.

Nor does A conduct business like an insurance company. Although A meets the minimum capitalization requirements of $250,000 established by the State of State 1, Department of Banking and Insurance, it appears to be substantially undercapitalized to meet its potential insurance risks for the policies written in Year1. A's potential maximum exposure for the 42 deductible reimbursement policies issued in Year1 is $5,390,000. However, prior to a capital contribution, at the end of December Year1, of a 99% interest in three limited liability partnerships, A lacked adequate capital to meet its potential insurance risk exposure. Absent the partnership contributions made by its parent and affiliates, A's net worth would have been $428,141.[4] If A had incurred substantial claims in Year1, related to the deductible reimbursement policies, A would not have had adequate capital to meet its risk obligations.

Only after the capital contribution of three partnership interests by its parent, at the end of December Year1, did A have adequate capital to meet its risk exposure. However, the partnerships were contributed to A, not to meet its potential risk exposure for the deductible reimbursement policies written in Year1, but to meet its potential risk exposure under the Representations and Warranties Policy for years Year2, Year3 and Year4. This position is supported by the fact that A discontinued the ADP, EPLI and Crime policies as of Year 1. According the Note 4 of the Year1 Financial Statement prepared by REPRENSATIVE 1 1, the capital contribution was described as follows:

* * * *

[4] Initial capital stock $100,000; Paid in capital $150,000 and Retained Earnings of $178,141.

On Year 1, a 99% interest in three limited liability partnerships was contributed by affiliates to A. The partnerships own hotel properties and are stated at their net equity in the statement of admitted assets, liabilities and surplus.

The CPA Financial Statement reported the partnership interest at their net equity value of $21,772,352. Since the capital contribution was made on the last day of the tax year, A, in effect, operated for the entire year of Year1 without sufficient capital to meet its potential risk exposure under the deductible reimbursement policies.

A filed an amended business plan with the State of State 1, Department of Banking, Insurance and Securities, on April 4, Year2. The purpose of the amended plan is summarized in a letter prepared by F as follows:

"C/H'S desire to write Representations and Warranties (R&W) in A has now been formalized. Commensurate with this goal, attached is documentation to explain the R&W program including a Business Plan, a Proforma Financial Statement and a Pricing Memo. Need for a R&W Policy arose when M&C completed a corporate transaction whereby M&C agreed to transfer certain third party management contracts, of certain unrelated hotel properties, to a newly created U.S. company, S, Inc., in exchange for a 15% interest in

. Perhaps the most significant exposure in this transaction is what is referred to as the "W." Coverage for this exposure as well as taxes and claims asserted by employees under the terms of the agreement would be difficult to purchase on the market as further explained in the attached Business Plan.

The policy is to be issued by A to S, Ltd., the insured, and to T, Ltd. and S Inc. as additional insureds. The ultimate parent of

> A and the insureds is T Limited. A's limit of liability is $5,000,000. The total premium for the six year policy is $750,000."

The Representations and Warranties Policy is A's only line of business for years Year2, Year3, and Year4. The business plan referenced the $22.2 million capital contribution received by A from its affiliates. A received partnership interests in Partnership 1 ($3,167,774), Partnership 2 ($9,498,499), and U, Ltd. ($9,506,079). The business plan indicates, "in the event of a catastrophic claim, A may secure a mortgage loan on the hotel properties to pay the claim."

In the Date 3 response to Information Document Request #2, POA 1, CPA with REPRESENTATIVE 1, explained the need for the additional capital as follows:

> A has accumulated assets in excess of $23 million as of Year 1 because of the potential loss exposure on the insurance programs written and the capital requirements of the State of State 1. Additionally, the investments held by A were illiquid resulting in a need to ensure that there was a sufficient capital base to pay potential claims in the event certain assets could not be liquidated or pledged to satisfy claims.

Based on the sequence of events and facts reviewed during the audit, it is clearly evident that although A reported net assets of $22.2 million on its Year1 Form 990, the assets were not held to meet its risk exposure for the ADP, EPLI, and Crime policies written during the year. All evidence leads the Service to conclude that had A incurred a catastrophic claim in Year1, the company would have been unable to meet its insurance obligations. Therefore, since the company was significantly undercapitalized in Year1, A did not conduct business consistent with traditional insurance companies.

B. Does A, a domestic company, continue to qualify for exemption from federal income tax as an organization described in I.R.C. § 501(c)(15)?

Facts:

A ("A") was incorporated, as a pure captive insurance company, in the State of State 1 on Date 1. The firm of Paul, Frank & Collins, Inc. was the initial agent of A. Under Article IV of the Articles of Incorporation, A is authorized to issue 200,000 shares with a $1 per share par value. B, the sole shareholder, purchased 100,000 shares of A on April 3, 1998, for an initial capital contribution of $100,000.

A is wholly owned by B. B and its sister entity, C are subsidiaries of D. C is the parent of E. As a domestic corporation, A is not required to make a section 953(d) election.

A filed an application on Form 1024 for recognition of exempt status under I.R.C. § 501(c)(15). A filed its Form 1024 application in January Year2. A Form 8718, User Fee for Exempt Organization Determination Letter Request, was also received by the Internal Revenue Service in January Year2. The application package included Articles of Incorporation endorsed by the Secretary of State for the State of State 1, on Date 1. The application also included a copy of the corporate Bylaws, which were adopted on July 2, 1998.

Around February Year 2, the Form 1024 application was referred to the national office for ruling.

In its application for recognition of exempt status, A represented it operated, and would operate in the future, as follows:

Current Program

> For the year ended Year 1, A Assurance ("A") provided insurance policies to third party hotels for which A's Parent, E Inc. ("C") and affiliates had negotiated management contracts to serve as the hotel's management. As such, Ewas compensated for providing such services as accounting, reservations, customer service, and insurance. With respect to the insurance placement, A provided deductible reimbursement coverage for Auto Physical Damage, Crime, and Employment Practices Liability to the third party hotels. The policies had various premiums and limits.

Due to a corporate transaction which caused Eto dispose of the management contracts, A will no longer issue these policies. The remaining reserves for the prior business will be maintained on A's books and these lines of business will be in run-off.

Future Program

Due to the above mentioned corporate transaction, E has transferred its interest in the above described management contracts to ("   "). In connection with the transfer of the management contracts, Eand its affiliates have agreed to indemnify

and its affiliates against certain pre-closing liabilities and representations and warranties delineated in the Contribution Agreement as amended.

Section 6.2 of the Agreement delineates the pre-closing liabilities and Section 6.4 places an aggregate limit of $5 million on these liabilities. Finally, Section 6.7 provides that M&C may satisfy its obligations with respect to section 6.2 by purchasing an insurance policy for the benefit of Swan. S has requested and E has agreed to insure S and its affiliates against potential claims arising from the pre-closing liabilities and representations and warranties utilizing A for the year Year2. A will continue to offer the coverage to S for up to six years.

Question 2 in Part II of the Form 1024 application requests financial information as follows: "List the organization's present and future sources of financial support, beginning with the largest source first." A's application made the following claims about financial support:

A is supported through the receipts of premiums for the issuance of insurance policies. In

addition, the Company generates investment income from premiums and capital.

Part III of the application, Financial Data, reflects A's actual figures for Year1 and prior three years. Part III of the application shows revenue from insurance premiums in the amount of $53,174 for Year1. A reported investment income of $101,339 and other income of $128,571 for Year1.[5] A received no premiums during the prior three years of operation. The same premium income information for Year1 ($53,174) is provided at Schedule I. No other sources of revenue were reported in Part III of the Form 1024 application.

Under Part III, Assets, A lists "cash" on line 1 of $385,213, "accounts receivable" on line 2 of $19,451, "bonds and notes receivable" on line 4 of $1,384,506, and "other investments" on line 7 of $1,772,352. No other assets were reported in Part III of the Form 1040 application.

Only an unsigned copy of the Form 1024 application was available for review during the audit process. The application listed , and as directors of A.

The application included an unsigned Form 2848, Power of Attorney authorizing POA 1, CPA with REPRENSATIVE 1 , Location 5; POA 2, CPA with REPRENSATIVE 1 in Location 6; and POA 3 with REPRENSATIVE 1 in Location 7, to represent A in connection with the Form 1024 application, Forms 1120PC and 990 for Year2 through 2006.

The Service by letter dated March 12, Year2, requested additional information from A. It asked for a schematic of the controlled group that A belongs to; a list of insurance policies issued in Year1; a copy of insurance policies issued in Year2; a copy of the Year1 Annual Report issued to the State of State 1; the relationship between

, and A's parent entity; and a copy of the Year2 financial statement. In its April 1, Year2 response, A provided a four page narrative responding to IRS questions; a schematic of the controlled group; a list of managed hotels and

* * * *

[5] A schedule included with the Form 1024 application shows "other income" was from "change in unearned financing liability."

premiums paid by each; a copy of the Representations and Warranties Policy issued in Year2; a copy of the Year1 Financial Report issued to the State of State 1; and a copy of A's Year2 Financial Statement.

In its response, A indicated that it issued a total of 42 deductible reimbursement policies to third party hotels in Year1. Under the terms, the policies indemnify the unrelated third party hotels against tort claims. On the Year2 financial statement, A reported "premium income" of $300,000, and investment income of $22,830, as of March 31, Year2. Under "assets" the balance sheet showed "cash of $329,409, accounts receivable of $175,848, and investments of $1,318,867, as of March 31, Year2. A reported total liabilities of $1,476,783 as of March 31, Year2.

The Service issued a favorable determination letter to A on May 14, Year2. The determination letter issued to A states:

> Based on the information supplied, and assuming your operations will be as stated in your application for recognition of exemption, we have determined you are exempt from federal income tax under section 501(a) of the Internal Revenue Code as an organization described in [section 501(c)(15)] commencing on January 1, Year1, for tax year(s) when your net written premiums (or, if greater, your direct written premiums) do not exceed the $350,000 limit as prescribed by this section 501(c)(15).
>
> Please notify the Ohio Employee Plans/Exempt Organizations (EP/EO) Customer Service office if there is any change in your name, address, sources of support, or method of operation.

A filed Forms 1120PC returns for tax years Prior Year 1 and Prior Year 2. Form 990 returns were filed for the tax years Year1, Year2, Year3, and Year4.[6] The Internal Revenue Service examined A's Form 990 for Year1, Year2, Year3, and Year4.

* * * *

[6] A also filed Form 990-T, Exempt Organization Business Income Tax Return, for tax years 2001, Year3, and 2003.

The Form 990 for Year1 was signed by the preparer at REPRENSATIVE 1 on October 8, Year 2, and by Officer 1, Vice President of A, on October 22, Year2. The Year1 Form 990 was filed postmarked on October 24, Year2, and received by the Service Center on October 29, Year2.

On examination, it was determined A had premium income of $53,174 in Year1, $340,238 in Year2, $300,000 in Year3, and $300,000 in Year4; and investment income totaling $101,340 in Year1, ($391,981) in Year2, ($517,218) in Year3, and $14,799 in Year4. The premiums for Year2 included $300,000 from S, Inc. under the Representations and Warranties Policy, and $40,238 of premiums formerly reported as "premiums held on deposit" and recognized as income in Year2. These figures, which were reflected on Forms 990 for Year1, Year2, Year3, and Year4, were confirmed by review of books and records.

Based on the examination of the activities and financial data for Year1 through Year4, the A's sole activity consisted of honoring a workers' compensation insurance policy sold to its affiliate, E., in 1997; and selling the deductible reimbursement auto, crime and employment practices liability policies in Year1, and the Representations and Warranties policy in Year2, Year3, and Year4.

From the date of inception through Year4, A incurred no insurance claims with respect to the workers' compensation, deductible reimbursement, and Representations and Warranties policies. A did establish loss reserves of $45,000, in Year1, to cover any potential future claims under the deductible reimbursement policies.

A reported minimal operating expenses during this period. A incurred typical organizational, general and administrative costs. A did not report the payment of salaries and wages because it hired no employees or other staff to conduct its business.

A provided no evidence that it conducted any other activities during the period of Date 1 through Year4.

There was no evidence of any material changes in A's operations from those described in its Form 1024 application and the operations actually conducted by A during the years under examination.

Law:

Section 501(a) of the Internal Revenue Code provides that organizations described in I.R.C. § 501(c) shall be exempt from income taxation. Section 501(c)(15) describes as exempt "insurance 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." I.R.C. § 501(c)(15). An organization is exempt under I.R.C. § 501(c)(15) only in those years in which it meets the $350,000 limitation on premium income. The premium income test includes amounts received by all entities in the exempt organization's controlled group. I.R.C. § 501(c)(15)(B), (C).

The exempt status of an organization may be recognized by the Internal Revenue Service through the application process described in a revenue procedure issued by the Service. See, e.g., Rev. Proc. 2005-4, I.R.B. 2005-1, 128, January 3, 2005; Rev. Proc. 90-27, 1990-1 C.B. 514. Although not required to apply for a determination letter in order to claim exempt status, organizations seeking recognition of exemption from the Internal Revenue Service under I.R.C. § 501(c)(15) must file a Form 1024, Application for Recognition of Exemption under Section 501(a).

A determination letter recognizing tax exempt status is issued by the Internal Revenue Service to an organization where its application and supporting documents establish that it meets the requirements of the category of exemption it claims. Rev. Proc. 90-27, § 5.01, 1990-1 C.B. 514. All information by the applicant must be provided under penalties of perjury. Rev. Proc. Year4-4, § 9.13, Year4-1 I.R.B. 123, 140-141. The application process ends with the issuance of a determination letter. A "determination letter" is a written statement issued by the Internal Revenue Service in response to a written inquiry by an individual or an organization that applies to the particular facts. Treas. Reg. § 601.201(a)(3).

If the Commissioner revokes the tax-exempt status of an organization, the remaining question is whether the revocation should be applied prospectively or retroactively. Generally, revocation of a determination letter is prospective. Rev. Proc. Year4-4, § 14.01 (cross-referencing § 13.01 et seq.). Revocation of a determination letter may, however, be retroactive if the organization omitted or misstated a material fact or operated in

a manner materially different from that originally represented. Treas. Reg. § 601.201(n)(6)(i); Rev. Proc. 90-27, §14.01; Rev. Proc. Year4-4, § 14.01 (cross-referencing § 13.01 et seq.).

Analysis

1. A Is Not Described in Section 501(c)(15) During the Years Under Exam.

To be exempt from federal income tax under I.R.C. § 501(a) as an entity described in I.R.C. § 501(c)(15), the entity must be an insurance company or association, other than life (including inter-insurers and reciprocal underwriters). In addition, it must meet a premium income requirement.

A producer-owned reinsurance company (PORC) like A is an "insurance company or association" for purposes of I.R.C. § 501(c)(15) if it issues insurance contracts, distributes and transfers insurance risks, and otherwise conducts business like an insurance company. As discussed at pages 16 through 30 of this report, A did not operate in accordance with the standards recognized by the Internal Revenue Service for an insurance company and, therefore, is not an insurance company for federal income tax purposes. Because the examination showed A is not an "insurance company," it is not eligible to retain its exempt status under I.R.C. § 501(c)(15).

In addition, an entity described in I.R.C. § 501(c)(15) in a given year must not have net written premiums (or, if greater, direct written premiums) for that taxable year in excess of $350,000. I.R.C. § 501(c)(15). The premium income test applies to all entities in the exempt organization's controlled group. I.R.C. § 501(c)(15)(B), (C). A is a member of a controlled group within the meaning of IRC 831(b)(2)(B)(ii), however, no other member of the controlled group is engaged in insurance business. A did not have net written or direct written premiums in excess of $350,000 for any year under examination.

Because A is not an "insurance company or association" during the years under exam, it is not exempt from federal income tax under I.R.C. § 501(a) as an entity described in I.R.C. § 501(c)(15), and thus, revocation of A's exempt status is appropriate.

2. A Cannot Rely on Its Determination Letter

An organization may not rely on a favorable determination letter if the organization omitted or misstated a material fact in its application or in supporting documents. An organization also may not rely on a favorable determination if there is a material change, inconsistent with exemption, in the organization's character, purposes, or methods of operation after the determination letter is issued. Treas. Reg. § 601.201(n)(3)(ii); Rev. Proc. 2005-4, I.R.B. 2005-1, 128, January 3, 2005; Rev. Proc. 90-27, 1990-1 C.B. 514.

The conclusion that A is not an "insurance company" during the years Year1, Year2, Year3, and Year4, rests primarily on an analysis of its sources of revenue and its business activities. See pages 16-40 of this report. In order to understand an organization's financial structure and activities and conclude that the organization is an insurance company and, therefore, entitled to be recognized as exempt, it is critical for the Service to have complete financial information and also a fair and accurate description of the organization's activities.

The following facts are critical to a determination of recognition of exemption under I.R.C. § 501(c)(15):

- Source of income

  (1) Primary source: A's primary source of revenue for Year1, Year2, Year3, and Year4 was insurance premium income. Premiums comprised 34.4% of total income for Year1; 83.3% for Year2; 70.7% for Year3; and 95.8% for Year4.[7] However, the Service determined that the premium income is not derived from insurance activities as defined in Helvering v. LeGierse, 312 U.S. 531, 539 (1941).

- Use of capital and efforts

  (1) No actual sales of insurance products. The only insurance products ever "sold" by A were the workers' compensation, deductible reimbursement and

* * * *

[7] Percentages for 2001 and Year3 were calculated independent of the partnership loss reported during each year.

Representations and Warranties policies to its affiliate, E. The majority (95%) of the insurance arrangements lack the characteristics of risk shifting and risk distribution.[8]

(2) Minimal effort. A devoted little time to its insurance activities, including the development and marketing of insurance products. Since its inception, A has not paid any claims under the workers' compensation, deductible reimbursement and Representations and Warranties policies.

Insurance activities: material misstatements. In Part II of the Form 1024 application, A described the actual insurance activities conducted in Year1 and the proposed activities for Year2. A disclosed the overall nature of its insurance activities in the Form 1024 application. However, the primary question is whether such activities meet the definition of "insurance" within the meaning of Helvering v. LeGierse, 312 U.S. 531, 539 (1941). The Service contends that the workers' compensation and deductible reimbursement policies, offered by A in Year1, do not constitute insurance because the arrangements lack the characteristic of risk shifting. In addition, the Representations and Warranties policy sold by A to S, Inc., in Year2, Year3, and Year4, does not constitute insurance because the arrangement lacks the characteristic of risk distribution.

3. Section 7805(b) Relief

While revocation of a determination letter is generally not retroactive, revocation of a determination letter may be retroactive if the organization omitted or misstated a material fact or operated in a manner materially different from that originally represented. Treas. Reg. § 601.201(n)(6)(i). See also, Rev. Proc. 2004-1, 2004-1 I.R.B. 1; Rev. Proc. 90-27, §14.01 (cross-referencing § 13.01 et seq.), 1990-1 C.B. 514. In cases where the organization omitted or misstated a material fact, revocation may be retroactive to all open years under the statute. See Treas. Reg. § 601.201(l)(1). In cases where revocation is due to a material change, inconsistent with exempt status, in the character, the purpose, or the method of

* * * *

[8] Based on percentage of premium income test.

operation, revocation will ordinarily take effect as of the date of the material change. Treas. Reg. § 601.201(n)(6)(i); Rev. Proc. 90-27. In any event, revocation will ordinarily take effect no later than the time at which the organization received written notice that its exemption ruling or determination letter might be revoked. Treas. Reg. § 601.201(n)(6)(i).

In this case, the agent recommends that revocation should be proposed for the year that A's activities were not consistent with the requirements of IRC 501(c)(15). The Service determined that A did adequately disclose its operations in the Form 1024 application. However, during the examination of tax years Year1, Year2, Year3, and Year4, the Service concluded that A did not operate primarily and predominantly for an insurance purpose because its workers' compensation, deductible reimbursement and Representations and Warranties policies with E. and S, Inc., respectively, do not constitute insurance.

The examining agent attempted to secure additional information with respect to the lines of business conducted by A during the years under examination. In particular, Information Document Request #3 was sent to POA 1, CPA for A, on September 14, 2004, with a response due date of October 8, 2004. After POA 1, CPA, requested extensions of time to October 31, 2004, and December 7, 2004, and failed to respond to the agent's follow-up requests to IDR #3, of November 18, 2004, and January 24, 2005, a final request was made of the CPA. On May 2, 2005, a letter was sent to , informing him that if no response to IDR #3 is received by June 30, 2005, the case will be closed based on the information obtained to date.

REPRENSATIVE 1 1 responded to IDR #3 on June 30, 2005. The response was submitted by . The response included an explanation for why E. is listed as the Named Insured on the deductible reimbursement policies (1 page); a breakdown of reserves by line of business as of Year 1 (2 pages); a reconciliation of premiums received in Year1 (5 pages); a copy of cancelled check, reconciliation and proof of bank deposit for premiums received by A in Year1 (4 pages); proof of bank deposit for premium received from E. for 1998 workers' compensation policy (4 pages); bank account documentation explaining the source of "premiums held on deposit" described in Note 6 to the Year2 REPRENSATIVE 1 1 Financial Statement (13 pages); schedule of claims paid by A (1 page) and a copy of cancelled checks written by A in Year1 (11 pages). The documentation submitted in

response to IDR #3 was reviewed by the examining agent and the relevant information was incorporated into this report.

Due to the length of time taken by A in responding to IDR #3 (approximately 8 months), and the relatively short statute (under 1 year remaining), a preliminary Form 886-A, Explanation of Items, was not sent to A for the purpose of soliciting a preliminary "Taxpayer's Position" regarding the proposed revocation action. Instead, the Service issued a 30 Day Letter, which included a copy of this report, Form 886-A, Explanation of Items. Under the 30 Day Letter procedures, A is afforded the usual appeal rights, provided the required minimum of 180 days is remaining on the statute of limitations.

After reviewing the activities for years Year1, Year2, Year3, and Year4, it was determined that A is not an insurance business, and does not meet the requirements for tax-exempt status under I.R.C. § 501(c)(15). Accordingly, revocation of exemption is proposed, effective January 1, Year1, the first day of the initial year under audit.

IV. TAXPAYER'S POSITION:

The examining agent received a phone call, on June 7, 2005, from , REPRESENTTIVE 1, in . stated that POA 1, representative for A, left the firm in May 2005. indicated that A would execute a new Form 2848, Power of Attorney authorizing a new representative. However, a new Form 2848, Power of Attorney was not received from REPRESENTTIVE 1 prior to the issue of this report. This report was sent to , who is listed as the second representative on the original Power of Attorney, and to Officer 1, Vice President of A.

Under usual circumstances, the Service may issue a preliminary report, Form 886-A, Explanation of Items, for the purpose of soliciting an informal position from the taxpayer. However, due to the length of time it took A to respond to IDR #3 (approximately 8 months), and the relatively short statute of limitations, the processing of the case was expedited by issuing a 30 Day Letter. No informal or preliminary position regarding the proposed revocation action was solicited from A. The 30 Day Letter procedure allows A to submit a formal written protest, in response to this report, before the case is forwarded to Appeals, provided at least 180 days remain on the statute of limitations.

V. CONCLUSIONS:

A, a domestic captive entity, is not an insurance company exempt from tax pursuant to I.R.C. § 501(c)(15) for the taxable years Year1, Year2, Year3, and Year4, and thus, revocation of its tax exempt status is proposed, effective January 1, Year1.

Explanation of Items. Under the 30 Day Letter procedures, A is afforded the usual appeal rights, provided the required minimum of 180 days is remaining on the statute of limitations.

After reviewing the activities for years Year1, Year2, Year3, and Year4, it was determined that A is not an insurance business, and does not meet the requirements for tax-exempt status under I.R.C. § 501(c)(15). Accordingly, revocation of exemption is proposed, effective January 1, Year1, the first day of the initial year under audit.

IV. TAXPAYER'S POSITION:

The examining agent received a phone call, on June 7, 2005, from , REPRESENTTIVE 1, in . stated that POA 1, representative for A, left the firm in May 2005. indicated that A would execute a new Form 2848, Power of Attorney authorizing a new representative. The new Power of Attorney was received on ___________, authorizing ___________, to represent A through the balance of the TE/GE examination.

Under usual circumstances, the Service may issue a preliminary report, Form 886-A, Explanation of Items, for the purpose of soliciting an informal position from the taxpayer. However, due to the length of time it took A to respond to IDR #3 (approximately 8 months), and the relatively short statute of limitations, the processing of the case was expedited by issuing a 30 Day Letter. No informal or preliminary position regarding the proposed revocation action was solicited from A. The 30 Day Letter procedure allows A to submit a formal written protest, in response to this report, before the case is forwarded to Appeals, provided at least 180 days remain on the statute of limitations.

V. CONCLUSIONS:

886A	Department of the Treasury - Internal Revenue Service **Explanation of Items**	Schedule No. or Exhibit
Name of Taxpayer **A**		**Year/Period Ended** Year 1 Year 2 Year 3

A, a domestic captive entity, is not an insurance company exempt from tax pursuant to I.R.C. § 501(c)(15) for the taxable years Year1, Year2, Year3, and Year4, and thus, revocation of its tax exempt status is proposed, effective January 1, Year1.