



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

TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

Number: **200644047**
Release Date: 11/3/2006

U.I.L. – 501.15-00

Date: 4/07/2006

No Third Party Contacts

Contact Person:

Identification Number:

Contact Number:

Employer Identification Number:

Form Required To Be Filed:
1120

Tax Years:

Dear _____ :

This is our final determination that you do not qualify for exemption from Federal income tax under Internal Revenue Code section 501(a) as an organization described in Code section 501(c)(15).

We made this determination for the following reason: You are engaged primarily in activities that do not constitute insurance for federal tax purposes.

You must file Federal income tax returns on the form and for the years listed above within 30 days of this letter, unless you request an extension of time to file. File the returns in accordance with their instructions, and do not send them to this office. Failure to file the returns timely may result in a penalty.

We will make this letter and our proposed adverse determination letter available for public inspection under Code section 6110, after deleting certain identifying information. Please read the enclosed Notice 437, *Notice of Intention to Disclose*, and review the two attached letters that show our proposed deletions. If you disagree with our proposed deletions, follow the instructions in Notice 437. If you agree with our deletions, you do not need to take any further action.

If you have any questions about this letter, please contact the person whose name and telephone number are shown in the heading of this letter. If you have any questions about your Federal income tax status and responsibilities, please contact IRS Customer Service at 1-800-829-1040 or the IRS Customer Service number for businesses, 1-800-829-4933. The IRS Customer Service number for people with hearing impairments is 1-800-829-4059.

Sincerely,

Lois G. Lerner
Director, Exempt Organizations
Rulings & Agreements

Enclosure
Notice 437
Redacted Proposed Adverse Determination Letter
Redacted Final Adverse Determination Letter



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

TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

U.I.L. – 501.15-00 No

Date:4/07/2006

Third Party Contacts

Contact Person:

Identification Number:

Contact Number:

FAX Number:

Employer Identification Number:

Legend:

M =

X =

Dear _____ :

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

You were incorporated in 2002 for the purpose of engaging in the business of insurance under the laws of the state of M. You are licensed as a captive insurance company. Your sole shareholder is X, a corporation that contracts with physicians and other medical service providers, as independent contractors, in providing their services to clients.

You have no employees. You issued one purported insurance contract each in 2002 and 2003 (the two years at issue). Each contract identifies X as the "Name Insured" and the following additional parties as "Insureds."

1. any managed care service organization in which the named insured owns or owned a controlling interest, but only as respects acts, errors or omissions occurring prior to sale or liquidation of the named insured's interest;
2. any present or former director, trustee, officer, medical director, or committee person (including person(s) acting at the direction of a committee), or partner of the named insured or of an insured while acting in such capacity, or for their liability as a result of such capacity or relationship with the insured;
3. any present or former employee of an insured while acting in such capacity;
4. any newly acquired or created insured if the named insured has notified the company within 90 days of acquisition or learning of by the named insured, whichever is later but only as respects acts, errors or omissions occurring after such acquisition or creation;¹
5. any joint venture or co-venture in which the named insured has an ownership interest;
6. any client of the named insured which the named insured agrees by contract to name as an insured prior to the institution of a claim, but only for liabilities covered: under this policy;
7. employed physicians, physician assistants, nurses and other employee are I covered while rendering emergency care or incidental medical services outside the scope of their duties as employees as long as the aid is rendered without the receipt or expectation of remuneration.

In addition, by endorsement, the contract "insured" includes approximately 30 physicians with respect to amounts they may be required to pay others as damages for bodily injury resulting from a medical incident arising out of medical services provided.

For each of the two policy years, the premium was paid by X on behalf of all the insureds.

You are applying for exemption under section 501(c)(15) for the tax years ending December 31,2002, and December 31,2003. You indicated you do not qualify for exemption under section 501(1)(c)(15) after December 31, 2003.

For 2002 and 2003, an insurance company other than life is exempt under section 501(c)(15)(A) if the written premiums for the taxable year do not exceed \$350,000. If an entity is a part of a consolidated group, section 501(c)(15)(B) provides that 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 section 501(c)(15)(A).

An organization's eligibility for the benefit of section 501(a) turns on whether it satisfies the criteria for qualification as an insurance company for federal income tax purposes. An organization's qualification as an insurance company depends on whether its activity constituted issuing insurance contracts or reinsuring the risks underwritten by an insurance company.

¹ You only insured X and have issued a liability insurance policy to X covering X's liabilities arising from the performance of services provided by its employees, physicians and other medical service providers .

For the years involved, for federal income tax purposes an insurance company 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. In addition, Treas. Regs. section 1.801-3(a) provides that "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." (Emphasis added.) This language resulted from a series of cases, including Lawyers Mortgage Co., *infra*, in which the United States Supreme Court established the test that later became incorporated as Treas. Regs. section 1.801-3(a), as follows:

While name, charter powers and subjection to state insurance laws have significance as to the business which a corporation is authorized and intends to carry on, the character of the business actually done in the tax years determines whether it is taxable as an insurance company. (Emphasis added).

285 U.S. at 188.

Although a taxpayer's name, charter powers, and state regulation help to indicate the activities in which it may properly engage, whether the taxpayer qualifies as an insurance company for tax purposes depends on its actual activities during the year. Inter-American Life Ins. Co. 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); *see also* 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." Industrial 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*, Lawyers Mortgage Co. at 188-90; Industrial 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); Service 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-Am. 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).

Because your only activity was providing coverage for X as "Named Insured", and enumerated physicians as "insureds", you are qualified as an insurance company for 2002 and 2003 only if this activity constituted issuing an insurance contract for federal income tax purposes.

Neither the Code nor the regulations thereunder define the terms "insurance" or "insurance contract." The bedrock for evaluating whether an arrangement qualifies as insurance is Helvering v. LeGierse, 312 U.S. 531, 539 (1941), in which the Supreme Court stated that "historically and commonly insurance involves risk shifting and risk distributing." The risk transferred must be risk of economic loss. Allied Fidelity Corp. v. Commissioner, 572 F.2d 1190, 1193 (7th Cir.), *cert. denied*, 439 U.S. 85 (1978). The risk must contemplate the fortuitous occurrence of a stated contingency, Commissioner v. Treganowan, 183 F.2d 288, 290-91 (2^d Cir. 1950), and must not be merely an investment or business risk. LeGierse, at 542; Rev. Rul. 89-96, 1989-2 C.B. 114.

Risk shifting occurs if a person facing the possibility of an economic loss transfers some or all of the financial consequences of the potential loss to the insurer, such that a loss by the insured does not affect the insured because the loss is offset by the insurance payment. Risk distribution incorporates the statistical phenomenon known as the law of large numbers. Distributing risk allows the insurer to reduce the possibility that a single costly claim will exceed the amount taken in as premiums and set aside for the payment of such a claim. Insuring 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). Risk distribution necessarily entails a pooling of premiums, so that a potential insured is not in significant part paying for its own risks. Humana Inc. v. Commissioner, 881 F.2d 247, 257 (6th Cir. 1989).

Under the facts as provided, you issued one purported insurance contract in each of the two years at issue. Each contract names X as the "Named Insured" and additional parties as "Insureds" as listed earlier.

Rev. Rul. 2002-89, 2002-2 C.B. 984, set forth circumstances under which arrangements between a domestic parent corporation and its wholly owned subsidiary constitute insurance and explained that a parent/wholly owned subsidiary arrangement does not constitute insurance if the parent accounts for 90% of the risk, but does qualify if other insureds constitute more than 50% of the risk.

Rev. Rul. 2005-40, 2005-27 I.R.B. 4, July 5, 2005, explains that a parent/subsidiary arrangement does not qualify as insurance if the issuer of an "insurance" contract enters into such a contract with only one policyholder or if one insured accounts for 90% of the risks.

In your case, even though there are purportedly multiple insureds under the policy, the only risks insured are those that arise in connection with providing medical services to Named Insureds' own clients. You have provided no basis for distinguishing between, on the one hand, the risks of the various Insureds other than the Named Insured and, on the other hand, the risks of the Named Insured. To the contrary, it appears likely that a claim against any Insured would necessarily entail a claim against the Named Insured as well. Under these facts, you have provided no basis to distinguish this case from Rev. Rul. 2005-40. See also Rev. Rul. 60-275, 1960-2 C.B. 43. (Annual "premium deposit" paid by a taxpayer under a "subscriber's agreement" with a reciprocal flood insurance exchange as a reserve self-insurance, is not deductible under section 162 of the Code as an insurance premium.)

Accordingly, you do not qualify for exemption as an organization described in section 501(c)(15) of the Code and you must file federal income tax returns.

You have the right to file a protest if you believe this determination is incorrect. To protest, you must submit a statement of your views and fully explain your reasoning. You must submit the statement, signed by one of your officers, within 30 days from the date of this letter. We will consider your statement and decide if the information affects our determination.

You also have a right to request a conference to discuss your protest. This request should be made when you file your protest statement. An attorney, certified public accountant, or an individual enrolled to practice before the Internal Revenue Service may represent you. If you

want representation during the conference procedures, you must file a proper power of attorney, Form 2848, *Power of Attorney and Declaration of Representative*, if you have not already done so. For more information about representation, see Publication 947, *Practice before the IRS and Power of Attorney*. All forms and publications mentioned in this letter can be found at www.irs.gov, Forms and Publications.

If you do not intend to protest this determination, you do not need to take any further action. If we do not hear from you within 30 days, we will issue a final adverse determination letter. That letter will provide information about filing tax returns and other matters.

Please send your protest statement, Form 2848 and any supporting documents to this address:

Internal Revenue Service
TE/GE, SE:T:EO:RA:T:3

1111 Constitution Ave, N.W.
Washington, D.C. 20224

You may also fax your statement using the fax number shown in the heading of this letter. If you fax your statement, please call the person identified in the heading of this letter to confirm that he or she received your fax.

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

Sincerely,

Lois G. Lerner
Director, Exempt Organizations
Rulings & Agreements