INTERNAL REVENUE SERVICE

TE/GE TECHNICAL ADVICE MEMORANDUM

Number: **200807018**
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235196

No Third Party Contact, Index (UIL) No.: 501.15-00

Area Manager – Gulf Coast

Taxpayer's Name:
Taxpayer's Address

Taxpayer's Identification Number:

Year Involved:

Conference Held:

LEGEND:

M =
N =
O =
P =
Q =
Date 1 =
Date 2 =
Year 1 =
x =
y =
z =

ISSUES:

A. Does M meet the gross receipts and premium requirements of section 501(c)(15) of the Internal Revenue Code?

B. Is M an insurance company as described section 501(c)(15) of the Code?

C. Can M continue to rely on its initial determination letter, which recognized the organization's exempt status under section 501(c)(15) of the Code, for the year at issue, if the organization did not operate as an "insurance company", as that term is used in section 501(c)(15)?

D. If M cannot continue to rely upon its initial determination letter, does M qualify for relief under section 7805(b) of the Code in the circumstances presented?

E. If the Commissioner exercises discretion to grant relief under section 7805(b) of the Code, what is the effective date of revocation?

F. In the alternate, if M is held to continue to rely upon its initial determination letter dated August 20, 1998, recognizing it as exempt under section 501(c)(15) of the Code, will M be subject to tax on unrelated business income with respect to rental income received from M property?

FACTS:

M was incorporated in the in Year 1 and received an exemption letter on Date 1 recognizing it as exempt from federal income tax as an organization described in section 501(c)(15) of the Internal Revenue Code effective Date 2. M has elected under section 953(d) of the Code to be treated as a U.S. corporation for U.S. tax purposes.

M is 100% owned by N. The policies written cover N, Inc., O, and P, and related entities. N and his wife each have a % partnership interest in O and P. N, Ltd. owns a % interest in O and P. N and his wife each own % of N, Inc. stock.

M's stated insurance activities are to write policies covering Third Party Environmental liability on storage tanks leased to customers, Automobile Damage to automobiles resulting from car wash facilities and car wash equipment, and Tank Damage covering damage resulting from Acts of God, and unintentional misuse, destruction, or mutilation.

Specifically, in , M wrote three insurance policies, as described below:

M's Third Party Environmental liability contract covers storage tanks located on third party properties that are leased to N, Inc. customers for monthly lease payments. The monthly lease payments include the premium payment. Over storage tanks are covered that include large above-ground tanks, small above-ground tanks, and below-ground storage tanks. Coverage is limited to $ million per occurrence.

Customers leasing tanks from N, Inc. are required to obtain Tank Damage coverage for tanks, gauges, and fittings. M's tank damage coverage covers tanks and is limited to $ per tank.

M's Automobile Damage coverage is provided to customers of N, Inc. and related entities for automobile damage resulting from customers' unintentional misuse of wash equipment. The price charged to customers includes the premium. Automobile damage coverage is limited to $ per occurrence.

M filed Form 990 for and reported $x million in assets and $y thousand in claims. M also reported rental income of $z thousand received from the Q Trust. M is the sole beneficiary of Q Trust.

LAW and ANALYSIS:

A. Does M meet the gross receipts and premium requirements of section 501(c)(15) of the Internal Revenue Code?

For taxable years beginning after December 31, 2003, section 501(c)(15)(A)(i) provides, in relevant part, for exemption for "insurance companies other than life (including interinsurers and reciprocal underwriters) if (i) (I) the gross receipts for the taxable year do not exceed $600,000 and (ii) more than 50 percent of such gross receipts consist of premiums." For purposes of determining gross receipts, the gross receipts of all members of a controlled group of which the company is part are taken into account

Because the gross receipts and premium requirements are based on the new law effective after December 31, 2003, and M has conceded it will not meet the new law, M will not be exempt for years beginning January 1, 2004.

B. Is M an insurance company as described section 501(c)(15) of the Code?

Under section 501(a) of the Code, organizations described in subsection 501(c) are exempt from federal income tax unless such exemption is denied under section 502 or 503.

For tax years beginning before January 1, 2004, section 501(c)(15)(A) of the Code provided an exemption from federal income tax for 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 did not exceed $350,000.

Section 501(c)(15)(B) of the Code provided that when an entity was part of a controlled group, all net written premiums (or direct written premiums) or net written premiums of the members of the group were aggregated to determine

whether the insurance company met the requirements of section 501(c)(14)(A).

Neither section 501(c)(15) of the Code nor the regulations under that section define an "insurance company." Accordingly, the term "insurance company" has the same meaning under section 501(c)(15) as it does in Subchapter L. See H. Conf. Rep. No. 99-841, 99th Cong., 2nd Sess. (Vol.II) 370-71, reprinted in 1986-3 (Vol.4) C.B. 370-71.

The business of an insurance company necessarily includes substantial investment activities. Both life and nonlife insurance companies routinely invest their capital and the amounts they receive as premiums. The investment earnings are then used to pay claims, support writing more business or to fund distributions to the company's owners. The presence of investment earnings does not, in itself, suggest that an entity does not qualify as an insurance company.

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. Section 1.801-3(a)(1) of the Income Tax Regulations; section 816(a) of the Code (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).

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.

In Rev. Rul. 2002-89; 2002-2 C.B. 984, the Service provided guidance on whether arrangements between a parent and a subsidiary insurance company qualified as an insurance arrangement and whether premiums paid were deductible under section 162 of the Code. Specifically, Situation 1 described a domestic corporation that entered into an annual arrangement with its wholly-owned insurance subsidiary. In doing so, the subsidiary either insures or reinsures the liability risks of the parent corporation. All business is maintained separately and the parent does not guarantee the subsidiary's risks. Also, 90 percent of the total premiums are received from the parent corporation on both a gross and net basis. The Service pointed out that when the total risk and liability coverage is more than 90 percent for the subsidiary; there is no risk shifting and

risk distribution. Accordingly, the Service held that there was no insurance arrangement and that amounts paid by the parent to the subsidiary were not deductible under section 162.

Rev. Rul. 2002-90, I.R.B. 2002-52, December 10, 2002, held that a subsidiary's arrangement to provide liability insurance coverage to 12 of its parent company's subsidiaries constituted insurance contracts for federal tax purposes and, thus, the amounts paid as premiums by each subsidiary were deductible as business expenses. Under the arrangement, the subsidiaries were charged arm's length premiums, according to customary industry ratings, and none had liability coverage for less than 5 percent, or more than 15 percent, of the total risk insured by the subsidiary. As a result, the professional liability risks of the 12 subsidiaries were shifted to the insurer subsidiary as required to constitute an insurance contract for federal tax purposes. The common ownership of the subsidiaries, including the insurer, by the parent, did not affect the determination that the arrangements constituted insurance contracts.

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).

While 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. 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); 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. 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 Lawyers Mortgage Co., supra, the Court concluded the taxpayer was not an insurance company based on the character of the business actually done. The taxpayer was chartered as "Lawyers Mortgage Insurance Co." to examine titles and to guarantee or insure bonds and mortgages. Later, the company dropped "insurance" from its name and amended its charter to allow the purchase and sale of mortgage loans. It remained under the supervision of the state insurance department. However, Lawyers Mortgage never insured titles. Rather, it made mortgage loans which it sold with a guarantee of payment. For this "insurance", Lawyers Mortgage charged a "premium" of one-half of one percent of the interest stated on the mortgage. The company also guaranteed the payment of some loans which it did not make or sell. Under state law, companies chartered as banks were also authorized to conduct this type of business. The Court concluded that though the guarantees were in legal effect insurance, this element of Lawyers Mortgage's activities was only incidental to the mortgage business; the "premium" covered non-insurance services. And the "premiums" were only one-third of Lawyers Mortgage's income. The character of the business actually done was not insurance, therefore, the company was not an insurance company.

Similarly, in Industrial Life Ins. Co., supra, the taxpayer was not an insurance company for federal income tax purposes because it was not using its capital and efforts primarily to earn income from insurance. Industrial Life was chartered as an insurance company but did not maintain a sales staff. Its office was located in the home of its president. During the three years at issue, the company's insurance activity consisted of covering small credit risks under a group policy issued to a consumer lender, covering the lives of certain of its officers (the company paid the premiums and was the beneficiary), and covering the lives of members of the stockholding family. The company also engaged in

leasing and selling real estate and managing its investment portfolio. Industrial Life's premium income from insurance issued to parties unrelated to its owners/officers (i.e., the group credit risk policy) accounted for approximately 8% its income during the years at issue. The company accumulated substantial earnings without showing a reasonable need. The district court concluded that Industrial Life was not an insurance company during the years at issue. Although it was involved in direct underwriting, it issued only one policy and its premium income was small compared with its income from its real estate activity.

Inter-American Life Ins. Co., supra, likewise involved a taxpayer that did not qualify as an insurance company due to its minimal volume of insurance business. Two individuals formed Investment Life Insurance Company to directly underwrite coverage which could be ceded to Inter-American. Although Inter-American was authorized to use several policy forms, it did not solicit or sell any directly written coverage during the years at issue. Rather, it accepted a small amount of business ceded to it by Investment Life and an unrelated insurer. Inter-American also held the family's lumber business as loaned surplus. Because of its minimal insurance activity, the state insurance commissioner became concerned about its continued participation in the insurance market. As a result, rather than surrender its certificate of authority to write insurance, Inter-American retroceded a major portion of its coverage to an unrelated company. Meanwhile, Inter-American realized income from various capital assets. Although Inter-American had as many as 448 policies in force during the five years at issue with an aggregate coverage of $1.4 million, premiums accounted for 5% or less of Inter-American's income during four of the five years. The court concluded that Inter-American was not an insurance company for any of the years at issue because it did not use its efforts in the insurance business. It did not actively solicit to issue coverage. Its directly underwritten coverage was issued to the owner's family or their tax advisor and its reinsurance was from the related company, Investment Life. Its investment income far exceeded its de minimis earned premiums.

In contrast, the taxpayer in Service Life Ins. Co., supra, was held to be an insurance company under different facts. During the years at issue, Service Life issued life, health and accident policies, and also solicited and arranged mortgage loans with money borrowed from the Federal Home Loan Bank. Between 35,000 and 70,000 policies were in force during the years at issue, representing life coverage of over $22,000,000. At the same time, only about 1,800 mortgages were outstanding. Service Life's premium income accounted for between 57% and 79% of its total income. Under these facts, the character of the business actually done by Service Life during the years at issue was insurance; hence it was an insurance company.

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 is devoted primarily to its insurance business.

M's policy contracts do not constitute "insurance" because they do not involve both risk-shifting and risk-distribution, as established in Helvering v. LeGierse, 312 U.S. 531 (1941). In making this determination, the terms "risk-shifting" and "risk-distribution," as defined within Rev. Rul. 2002-90, were applied.

On the element of risk distribution, the "additional insureds" – the customers, suppliers, etc. – are not legally recognizable insureds because the contracts do not appear to be a result of the bargain between M and these entities; these "additional insureds" – particularly the customers of the carwashes – were apparently unaware of the existence of these policies. M argues that the contracts fulfill the "service agreements" and provide protection for the users of the carwashes. However, these service agreements require coverage for risks of types other than that provided by the contracts. Though M asserts that the consideration either for the service agreements or for the use of the car wash supported the contracts, nothing in the agreements or the terms of use of the carwash substantiates this assertion. Because these practices are seemingly at odds with those commonly associated with insurance arrangements, these "additional insureds" arguably should not be recognized as such. In this respect, the contracts do not constitute insurance for federal income tax purposes.

In addition, since M's tank damage, auto-damage, and environmental liability policies each involve only one insured party, they do not involve risk distribution, which requires the statistical phenomenon known as the law of large numbers. Distributing risk allows the insurer to reduce the possibility that a single costly claim will exceed the amount taken in as premiums and set aside for the payment of such a claim. By assuming numerous relatively small, independent risks that occur randomly over time, the insurer smooths 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. [See Humana Inc. v. Commissioner, 881 F. 2d 247, 257 (6th Cir. 1989).]

M's policies' lack of risk distribution is further evident by comparing them with the liability insurance coverage provided by the captive insurer discussed within Rev. Rul. 2002-90. In Rev. Rul. 2002-90, twelve subsidiaries comprising the insured parties and the insurer had common ownership by a parent company. None of the insured parties had less than 5 percent or more than 15 percent of the total risk insured by their affiliated, meaning that the parent company's common ownership of the insured subsidiaries and the insurer did not impact the determination that the arrangements constituted insurance contracts. In contrast,

the insured parties under M's tank damage and auto-damage policies had 100% of the total risk because they were the sole insured under these policies. [Also, see Humana Inc. v. Commissioner, supra.]

C. Can M continue to rely on its initial determination letter, which recognized the organization's exempt status under section 501(c)(15) of the Code, for the year at issue, if the organization did not operate as an "insurance company", as that term is used in section 501(c)(15)?

As discussed above, M did not qualify for exemption under section 501(c)(15) of the Code for because the each insurance policies involved only one insured party, thus, lacking risk distribution. M's insurance policies written in were the same insurance policies written for subsequent years. Since the policies were not considered insurance for , the same policies would not be considered insurance for subsequent years.

CONCLUSIONS:

A. M does not meet the gross receipts and premium requirements of section 501(c)(15) of the Internal Revenue Code after December 31, 2003.

B. M is not an insurance company as described section 501(c)(15) of the Code for the year at issue.

C. M can not continue to rely on its initial determination letter, which recognized the organization's exempt status under section 501(c)(15) of the Code, for the year at issue, since the organization did not operate as an "insurance company", as that term is used in section 501(c)(15).

D. M does not qualify for relief under section 7805(b) of the Code under the circumstances presented.

E. The Commissioner exercises discretion to deny relief under section 7805(b) of the Code. The effective date of revocation of exemption is January 1, , the year in which M was recognized as exempt under section 501(c)(15) of the Code.

- END -