INTERNAL REVENUE SERVICE

TE/GE TECHNICAL ADVICE MEMORANDUM
November 2, 2007

Number: **200809045**
Release Date: 2/29/2008

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

Area Manager –

Taxpayer's Name:
Taxpayer's Address

Taxpayer's Identification Number:

Years Involved:

Conference Held:

LEGEND:

D =
E =
F =
G =
M =
N =
O =
O#1 =
O#2 =
P =
Q =
Q#1 =
Q#2 =
R =
S =
T =
U =
V =
W =
X =

Year 1 =
Year 2 =
Year 3 =
Year 4 =
Year 5 =
Date 1 =
Date 2 =
Date 3 =
Date 4 =
Date 5 =
Date 6 =
Date 7 =

$a =
$b =
$c =
$d =
$e =
$f =
$g =
$h =
$i =
$j =
$k =
$l =
$m =
$n =
$o =
$p =
$q =
$r =
$s =
$t =
$u =
$v =
$w =
$x =
$y =
$z =
$aa =
$bb =
$cc =
$dd =
$ee =
$ff =
$gg =

$hh =
$ii =
$jj =
$kk =
$ll =
$mm =
$nn =

ISSUES:

1. Is M an insurance company exempt from tax pursuant to section 501(c)(15) of the Internal Revenue Code, for the taxable years , and (Years Involved)?

2. Is M's primary and predominant business activity its investments?

3. Can M rely on the determination letter granted by the Service allowing it to claim tax exempt status pursuant to 501(c)(15) of the Code?

4. Is M entitled to relief pursuant to section 7805(b) of the Code?

5. If M cannot rely on its determination letter, what is the effective date of revocation?

FACTS:

M was incorporated as a life and disability reinsurer under the laws of D 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 Code effective on Date 2.

M's purpose is to transact life and disability insurance. M conducts its insurance business as a domestic second and third tier reinsurer.

M is wholly owned by N. N is a U. He has also worked in the V department of various insurance companies. Since Year 2 he has acted as a W.

In addition to M, N owns/controls E, F, and G. During the Years Involved, each of these entities provided service or value to M for which they were compensated.

During the Years Involved, M had in force the following retrocession agreements under which it was liable to the retrocessionaire:

1. Retrocessional Agreement with O#1

This agreement was effective January 1, 1990 and provided that M assumed 1% of the credit accident and health coverage assumed from T Insurance Company. This agreement was effective throughout the Years Involved.

2. Reinsurance Agreement with O#2.

This agreement was effective Date 3 and throughout the Years Involved. It provided that M assumed 1% of the credit accident and health coverage O#2 assumed from P Insurance Co. on/after Date 4. As stated in a report by the D Department of Insurance, as of Date 5, this block of business was in run-off with no reported premiums, claims, or reserves after Date 6.

3. Retrocession Agreement with Q#1

This agreement was effective Date 7 and throughout the Years Involved. It provided that M assumed 10% of the accident and health coverage on group policies which Q assumed from R. Article V of this agreement provided that M was to receive 20% of the net ascertained profit, including profit in excess of 5% of the net premium on life reinsurance business associated with the ceded accident and health business.

R appears to be a congregation of insurance companies[1] which desired to cede a portion of their business while retaining the associated life insurance business.

Q was in force during the Years Involved.[2]

4. Quota Share Retrocession Agreement with Q#2.

This agreement was effective July 1, 2001 and provided that M assumed .2% of the share of medical reinsurance (including dental, vision, and short-term disability) borne by Q pursuant to its Underwriting Management Agreement with S Management Partnership. It excluded noncancellable and guaranteed renewable on a "form following"[3] basis. This agreement terminated June 30, 2002.

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[1] Most of which have "Life" in their name, e.g., "   ".
[2] The copy of the agreement provided in the file has information through November 30, 1994. However, the Year 5
Report of Examination by the D Department of Insurance presumes that Q#1 was in effect throughout the period of examination (   ).
[3] What is meant by "form following" is not clear.

Nothing suggests that O or Q Insurance Co. do not qualify as an insurance company.

M notes that the maximum potential liability for all of these contracts was at least $26.2 million during Year 3, $40.6 million during Year 4, and $33.6 million during Year 5.[4] M's reserve for claims was $l for Year 3, which was 0.38% of its statutory surplus of $m; was $x for Year 4, which was 0.34% of its statutory surplus of $y; was $kk for Year 3, which was 0.31% of its statutory surplus of $ll.

The companies which retroceded coverage to M were authorized to claim surplus relief.

During the Years Involved, M's assets were invested in securities, primarily government grade debt instruments (U.S. Treasury obligations; collateralized mortgage obligations issued by the Federal National Mortgage Association) or index/sector mutual funds. The remainder of the assets was represented by a note payable by N and his wife secured by real estate. The investment of the assets generated income. This income, plus at least some of the premium revenue, was also invested. Doing so required many separate transactions. M states that because it invested in high-grade securities, this investment activity was "automatic" or required only de minimis activity.

For each of the Years Involved, M filed a Form 990, Return of Organization Exempt from Income Tax and an annual statement with the D Department of Insurance.

On its Year 3 Form 990, M reported as program service revenue[5] $a, which was comprised of $b in premium income and a decrease in aggregate reserves of $c. Reported investment income was $d, of which $e was for a change in asset valuation. This was offset by reported expenses of $f (of which $g were attributed to "unrealized losses"); no expenses were reported as related to the program service; though under "management and general" M reported "benefits paid" of $h. Reported assets were $I and liabilities were $j, of which $k was for the unearned premium reserve and $l was for "present value on claims not due."

M filed its Year 3 annual statement using a life and accident and health blank. M reported a statutory surplus of $m and an "asset valuation reserve" of $n. The annual statement indicates that in the course of the transactions involving its investments, M received gross proceeds of $o.

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[4] This computation by M reflects only O #1 and Q#2; M concludes that the potential liability for O#2 and Q#1 is indeterminable.

[5] We interpret "program service revenue" to be that from the exempt purpose, in this case insurance.

On its Year 4 Form 990, M reported program service revenue of $p, which was comprised of $q in premium income and a decrease in aggregate reserves of $r. Reported investment income was $s. This was offset by expenses of $334,007; no expenses were reported as related to the program service, though under "management and general" M reported "benefits paid" of $t. Reported assets were $u and liabilities were $v, of which $w was for the unearned premium reserve and $x was for "present value on claims not due."

M filed its Year 4 annual statement using a life and accident and health blank. M reported a statutory surplus of $y and an "asset valuation reserve" of $z. The annual statement indicates that in the course of the transactions involving its investments, M received gross proceeds of $aa.

On its Year 5 Form 990, M reported program service revenue of $bb, which was comprised of ($651) in premium income and a decrease in aggregate reserves of $cc. Reported investment income was $dd, which included a "change in asset valuation" of $ee and "unrealized gains/losses" of ($ff). This was offset by expenses of $gg; no expenses were reported as related to program services, though under "management and general" M reported "benefits paid" of $hh. Reported assets were $ii and liabilities were $jj, of which $47,708 was for unearned premium reserve and $kk was for "present value on claims not due."

M filed its Year 5 annual statement using a life and accident and health blank. M reported a statutory surplus of $ll and an "asset valuation reserve" of $mm. The annual statement indicates that in the course of the transactions involving its investments, M received gross proceeds of $nn.

M states that during the years involved, the bulk of its activities were connected with the contracts described above: O #1, O #2, Q#1, and Q#2. M concedes that it did not solicit any additional business during the years involved,[6] largely because of market conditions (except that it did enter into contract Q#2 during Year 4). M states that it could be viewed as undercapitalized during the years involved because the rules under which a ceding company can claim credit for reinsurance use a surplus of $20 million as a benchmark.[7] <u>See</u>, <u>e.g.</u>, D Rev. Stat. Ann. § 20-261.01(A)(2)(d); D Admin. Code § R20-6-1601(B)(4); paragraph 9 of Appendix A-785 of the Accounting Practices and Procedures Manual of the National Association of Insurance Commissioners. However, M took no action during the Years Involved to increase its surplus, e.g., obtain additional investors. Other than N, M had no employees or agents.

<u>Law:</u>

Section 501(c)(15) of the Code recognizes as exempt insurance

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[6] Apparently in 2004 M did consider, but ultimately declined, to enter into an agreement with to assume 10% of a block of life insurance.
[7] However, such a surplus is not a prerequisite for such credit.

companies or associations other than life (including interinsurers and reciprocal underwriters) if the net written premium (or, if greater, direct written premiums) for the taxable year do not exceed $350,000 for years prior to January 1, 2004. For years after December 31, 2003, the law was amended to state gross receipts can total $600,000 and premium income must be at least 50% of total gross receipts.

Qualification as an insurance company must be satisfied annually. Section 1.801-3(a)(1) of the Income Tax Regulations; 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).

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 Code; section 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).

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., at 877. 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 § 801).

In Lawyers Mortgage Co., 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 Indus. Life Ins. Co. 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.

Cardinal Life Insurance Co. involved a company chartered to write life, health and accident coverage. During two of the five years at issue, Cardinal Life did not issue insurance contracts or reinsure risks underwritten by insurance companies; its premium income was $0 and it had no reserves. For the remaining three years, Cardinal Life reinsured risks underwritten by an insurance company; its premium income was less than 1% of its income for two of those years and approximately 9% in the third. Its reserves were minimal. Cardinal Life never employed any agents or brokers though it did retain an actuary; the reinsurance agreement was negotiated by its one stockholder. Meanwhile, Cardinal Life had income from dividends and interest, leasing real estate and trailers, and capital gains. The district court concluded that Cardinal Life was not an insurance company because its capital and efforts were devoted primarily to its investment activity; it did not solicit insurance business and derived insignificant amounts of income from what insurance business it transacted while deriving substantial income from its investments.

Inter-American Life Ins. Co. 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. 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.

Analysis:

Issue 1: Is M an insurance company exempt from tax pursuant to section 501(c)(15) of the Internal Revenue Code, for the Years Involved? And

Issue 2: Is M's primary and predominant business activity its investments?

A review of M's activities during each of the Years Involved reveals that during none of these years was issuing insurance or annuity contracts or reinsuring risks underwritten by insurance companies its primary and predominant business activity. Though each year is to be examined separately, M's activities were common to each of the Years Involved such that the years can be discussed together.

During the Years Involved, M did not write "direct" coverage; rather, all of its insurance activities revolved around retrocessional agreements (i.e., reinsuring reinsurance). Nothing suggests that these contracts: O #1, O #2, Q#1, and Q#2 are not reinsurance contracts for federal income tax purposes. Accordingly, during the Years Involved M was reinsuring risks underwritten by insurance companies. This type of insurance activity can be sufficient to qualify as an insurance company. Alinco Life Ins. Co., supra.

Applying the "primary and predominant business activity" standard does not involve merely comparing the relative amounts of income from different sources such that if the amount of premium income is the largest portion or the majority of the company's income, the company will qualify as an insurance company. In the conduct of an insurance business an insurance company may have income other than premium income. Applying the standard involves asking if the company used its capital and efforts to earn income primarily and predominantly from insurance contracts. This entails examining all the facts and circumstances to ascertain the true nature of the company's business; comparing the relative amounts of income from different sources aids in doing so.

Here, as reported on the Forms 990, for each of the Years Involved, M had two sources of income: premiums and investments. M's premium income was de minimis compared to its investment income: for Year 3, premium income was 10.42% of its total income; for Year 4 it was 16.40%; and for Year 5 it was 25.75%. Though the market may not have been favorable during the Years Involved, M did not solicit writing any additional coverage (other than contract Q#2). M has not demonstrated that it was unable to assume additional risks;[8] its reserves were minimal compared to its surplus. M notes that its surplus was less

than half that suggested as appropriate for a reinsurer, yet it took no action to increase its surplus. And M engaged in many investment transactions during the Years Involved. M did not employ or otherwise procure services related to its insurance activities from anyone other than N. M's circumstances are similar to those of the taxpayer in Cardinal Life, which did not qualify as an insurance company.

Therefore, for each of the Years Involved, M did not qualify as an insurance company for federal income tax purposes because during none of these years M was issuing insurance or annuity contracts or reinsuring risks underwritten by insurance companies as its primary and predominant business activity.

Issue 3: Can M rely on the determination letter granted by the Service allowing it to claim tax exempt status pursuant to 501(c)(15) of the Code?

As discussed above, M did not qualify for exemption under section 501(c)(15) of the Code for the Years Involved because M was not reinsuring risks underwritten by insurance companies as its primary and predominant business activity. Therefore M can not rely on its determination letter for years beginning after Year 3.

Issue 4: Whether the Commissioner, TE/GE, should exercise his discretion to grant the subject organization relief under section 7805(b) of the Code limiting the retroactive effect of revocation of its exemption under section 501(c)(15).

Issue 5: If the Commissioner exercises discretion to grant relief under section 7805(b) of the Code, what is the effective date of revocation?

The effective date of revocation is January 1, 2004, the date M concedes it no longer qualified for exemption under section 501(c)(15) of the Code.

CONCLUSIONS:

1. M is not an insurance company exempt from tax pursuant to section 501(c)(15) of the Code, for the Years Involved.

2. For the Years Involved, M did not qualify as an insurance company because during none of these years M was issuing insurance or annuity contracts or reinsuring risks underwritten by insurance companies as its primary and predominant business activity.

3. M can not rely on the determination letter granted by the Service allowing it to claim tax exempt status pursuant to 501(c)(15) of the Code.

4. M is entitled to relief pursuant to section 7805(b) of the Code.

5. Since M can not rely on its determination letter, the effective date of revocation is January 1, 2004.

A copy of this technical advice memorandum is to be given to the taxpayer. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

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