Internal Revenue Service
Appeals Office

Number: **201652030**
Release Date: 12/23/2016

Date: September 26, 2016

ORG
ADDRESS

Certified Mail

Department of the Treasury

Employer Identification Number:

Person to Contact:

Employee ID Number:
Tel:
Fax:

Tax Period(s) Ended:

UIL: 0501.15-00

Dear :

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

The final adverse determination of your exempt status was made for the following reason(s):

You are not an insurance company within the meaning of subchapter L of the Internal Revenue Code because your primary and predominant activity is not insurance. The purported insurance and/or reinsurance transactions lack economic substance.

Organizations that are not exempt under section 501 generally are required to file federal income tax returns and pay tax, where applicable. For further instructions, forms, and information please visit www.irs.gov.

If you decide to contest this determination, you may file an action for declaratory judgment under the provisions of section 7428 of the Code in one of the following three venues: 1) United States Tax Court, 2) the United States Court of Federal Claims, or 3) the United States District Court for the District of Columbia. A petition or complaint in one of these three courts must be filed within 90 days from the date this determination letter was mailed to you. Please contact the clerk of the appropriate court for rules and the appropriate forms for filing petitions for declaratory judgment by referring to the enclosed Publication 892. You may write to the courts at the following addresses:

United States Tax Court
400 Second Street, N.W.
Washington, D.C. 20217

U.S. Court of Federal Claims
717 Madison Place, N.W.
Washington, D.C. 20439

U.S. District Court for the District of Columbia
333 Constitution Ave., N.W.
Washington, D.C. 20001

Processing of income tax returns and assessments of any taxes due will not be delayed if you file a petition for declaratory judgment under section 7428 of the Internal Revenue Code.

You may also be eligible for help from the Taxpayer Advocate Service (TAS). TAS is an independent organization within the IRS that can help protect your taxpayer rights. TAS can offer you help if your tax problem is causing a hardship, or you've tried but haven't been able to resolve your problem with the IRS. If you qualify for TAS assistance, which is always free, TAS will do everything possible to help you. Visit www.taxpayeradvocate.irs.gov or call 1-877-777-4778.

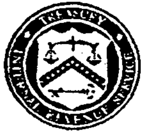
If you have any questions about this letter, please contact the person whose name and telephone number are shown in the heading of this letter.

Sincerely Yours,

Appeals Team Manager

Enclosure: Publication 892

cc:



DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
450 Golden Gate Avenue, Stop 7501
San Francisco, CA 94102

TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

Date: July 11, 2013

Taxpayer Identification Number:

Form:

Tax Period(s) Ended:

Person to Contact/ID Number:

Contact Numbers:
Telephone:
Fax:

Dear :

During our examination of the returns indicated above, we determined that your organization was not described in Internal Revenue Code section 501(c) for the tax periods listed above and therefore, it does not qualify for exemption from federal income tax. This letter is not a determination of your exempt status under section 501 for any periods other than the tax periods listed above.

The attached revised Report of Examination, Form 886-A, summarizes the facts, the applicable law, and the Service's position regarding the examination of the tax periods listed above. This report supersedes our report dated January 14, 2013. You have not agreed with our determination, or signed a Form 6018-A, Consent to Proposed Action, accepting our determination of non-exempt status for the periods stated above. You have not agreed to file the required income tax returns. You may appeal your case. The enclosed Publication 3498, The Examination Process, and Publication 892, Exempt Organizations Appeal Procedures for Unagreed Issues, explain 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 with Appeals, you must submit a written protest within 30 days of the date of this letter. An Appeals officer will review your case. The Appeals Office is independent of the Director, EO Examinations. Most disputes considered by Appeals are resolved informally and promptly.

You may also request that we refer this matter to IRS Headquarters for technical advice as explained in Publication 892. If you do not agree with the conclusions of the technical advice memorandum, no further administrative appeal is available to you within the IRS on the issue that was the subject of the technical advice.

If we do not hear from you within 30 days of the date of this letter, we will issue a Statutory Notice of Deficiency based on the adjustments shown in the enclosed report of examination.

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 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:

Taxpayer Advocate Service

In the future, if you believe your organization qualifies for tax-exempt status, and would like to establish its status, you may request a determination from the IRS by filing Form 1024, Application for Recognition of Exemption under Section 501(a), and paying the required user fee.

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,

Director, EO Examinations

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

Form 886-A (Rev. January 1994)	EXPLANATIONS OF ITEMS		Schedule number or exhibit
Name of taxpayer		Tax Identification Number	Year/Period ended 12/31/20 12/31/20 12/24/20

ISSUE:

1. Whether the contracts executed by constitute contracts of insurance?
2. Whether the arrangement entered into by involves the requisite element of risk distribution?
3. Whether more than half of the business of during each of the taxable years under consideration is the issuing of insurance or annuity contracts or the reinsuring of risks underwritten by insurance companies?
4. If is not an insurance company, does it qualify for treatment as a tax-exempt entity under section 501(c)(15) of the Internal Revenue Code?
5. Is treatment as an IRC 501(c)(15) tax exempt entity precluded if the organization does not have approval of its IRC 953(d) election?

FACTS:

("Taxpayer") was formed and incorporated in on December 31, 20 , under the provisions of Section 9 of the Companies Act, 2000. The taxpayer was formed to provide certain property and casualty insurance type services. The taxpayer is formed as a foreign captive insurance taxpayer. The taxpayer is authorized to issue common shares with a $ par value. The taxpayer actually issued shares in consideration of $ capital contribution. Each shareholder made an initial capital contribution of $ for common shares.

The taxpayer is co-equally owned by the , a , and by , a U.S. citizen and resident of the State of . Each shareholder owns a percent interest in the taxpayer. The is owned by the following entities:

	, general partner	%
	, general partner	
	, limited partner	
	, limited partner	
	, limited partner	
Total		100.00%

of , is a co-trustee of the , general partner; the and the , limited partner. The trustee of the is son of .

Form **886-A** (Rev. January 1994)	**EXPLANATIONS OF ITEMS**		Schedule number or exhibit
Name of taxpayer		Tax Identification Number	Year/Period ended 12/31/20 12/31/20 12/24/20

The TEGE examining agent obtained a copy of taxpayer's Form 1024 application administrative file from the Exempt Organizations Records Unit in on February 18, 20 . The administrative file included a copy of the Form 1024 application, Articles of Incorporation; the IRC 953(d) election; regulatory filings and responses of Insurance Regulators; insurance underwriting diagrams; organizational owner chart; supplemental information for the Form 1024; financial information for 20 and subsequent years: forms of credit reinsurance agreements entered into by the taxpayer; and a copy of the 20 insurance policies issued by the taxpayer. Other documents were received from , CPA, in response to Information Document Requests issued by the examining agent to the CPA during the audit.

According to the Articles of Incorporation, the taxpayer is to be governed by a board of directors composed of one to seven directors. The board is actually composed of two directors, and . represents the shareholder, . He also serves as Chief Executive Officer (CEO), President, Treasurer, and Assistant Secretary of : serves as Vice President, Secretary, and Assistant Treasurer of the taxpayer.

and are also owners of , and various other business interests collectively referred to as "Affiliated Business Interests." According to the taxpayer's Business Plan,

> The Affiliated Business Interests desired to insure certain of their property and casualty exposures, and are unwilling, or in some cases, unable to do so through the conventional insurance marketplace. The Affiliated Business Interests looked at alternative methods of arranging such insurance coverage and have found that providing such coverage through a captive insurance company offers the best method for satisfying its needs. will be operated primarily to accomplish this objective.

The taxpayer was created as a controlled foreign corporation. The taxpayer is not a member of a controlled group of corporations. As a controlled foreign corporation, , President, signed an IRC 953(d) election statement on February 23, 20 . It appears that the election statement was filed with the IRS office on the same day.

On September 18, 20 , the taxpayer filed Form 1024, Application for Recognition of Exemption Under Section 501(a), seeking exemption as a small insurance company under section 501(c)(15) of the Internal Revenue Code. The application revealed that 20 was the initial tax year of the taxpayer. Prior to filing the Form 1024 application, the taxpayer had filed Form 990 for the tax year ended December 31, 20 , with the Ogden Service Center.

Form 886-A (Rev. January 1994)	EXPLANATIONS OF ITEMS		Schedule number or exhibit
Name of taxpayer		Tax Identification Number	Year/Period ended 12/31/20 12/31/20 12/24/20

, President, signed the application on September 1, 20 . A Form 2848, Power of Attorney, accompanied the application authorizing , Attorney, and , Attorney, to represent the taxpayer during the application process. The attorneys worked for a law firm in .

The application revealed that the taxpayer employed , to serve as its resident insurance manager in . The taxpayer agreed to pay compensation of less than $ annually.

The Form 1024 application was referred to Rulings and Agreements in Washington, D.C., on October 14, 20 , for consideration and ruling. The application was assigned to a Tax Law Specialist on November 13, 20 . No action was taken on the application until July 20 . On July 10, 20 , the Tax Law Specialist mailed a letter to the taxpayer's registered agent in , and requested additional information about the operations. The taxpayer's response to the letter was due by August 21, 20 . , Attorney, submitted a letter dated August 19, 20 requesting an extension of time to respond until September 21, 20 .

Instead of responding to the additional information request of the Tax Law Specialist, the taxpayer's , submitted a letter on September 16, 20 , and requested that the Form 1024 application be withdrawn from further consideration and ruling. On September 22, 20 , the Tax Law Specialist closed the application file and issued a letter informing the taxpayer that their request to withdraw the application was accepted and no further action would be taken on the application.

Thus, the taxpayer did not receive a favorable or final adverse ruling letter from TEGE, Rulings and Agreements. In addition to not completing the exemption application process, there is no evidence that its IRC 953(d) election statement was approved by the Internal Revenue Service. On February 22, 20 , the TE/GE examining agent requested the effective date of the IRC 953(d) election from the IRS office. On February 28, 20 , the IRS office informed the examining agent that the Service does not have record that the IRC 953(d) election was approved.

The taxpayer filed a Form 990-EZ return for its initial tax year that consisted of a single day. The tax year began and ended on December 31, 20 . The taxpayer also filed Form 990-EZ for the 20 calendar year, which was its first full year of operation.

The taxpayer operated primarily to provide property and casualty "insurance" coverage to (" ") and (" "), which are owned and controlled by and , officers and beneficial owners of . The Financial Services Commission, , issued a Class 'B: General Insurance License to the taxpayer effective December 31, 20 .

Form 886-A (Rev. January 1994)	EXPLANATIONS OF ITEMS	Schedule number or exhibit
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In 20 , the taxpayer wrote ten direct-written "insurance" contracts to and titled: (1) Special Risk – Commercial General Liability GAP Insurance Policy; (2) Excess Directors & Officers Liability Insurance Policy; (3) Event Cancellation Insurance Policy; (4) Special Risk – Expense Reimbursement Insurance Policy; (5) Excess Intellectual Property Package Policy; (6) Special Risk – Loss of Major Business to Business Relationship Insurance Policy; (7) Special Risk – Loss of Services Insurance Policy; (8) Special Risk – Punitive Wrap Liability Insurance Policy; (9) Special Risk – Regulatory Changes Insurance Policy; and (10) Special Risk – Tax Liability Insurance Policy. Each policy listed and as joint insured. The taxpayer did not issue separate policies to and . Also, under the terms of each policy, the annual premium was treated as a combined premium that covered both insured, and . Each of the above-named policies is described in detail below.

Special Risk – Commercial General Liability GAP Insurance Policy provides reimbursement for claims which are denied by Employers Fire Insurance Company, under General Liability Policy Number , effective August 31, 20 , through August 31, 20 , which includes "exclusion/endorsement buy back" or "differences in conditions" coverage from an underlying commercial property, commercial general liability or other commercial insurance policy.

Excess Directors & Officer Liability Insurance Policy provides indemnification subject to certain limitations to and for their indemnification of its officers and directors for wrongful acts, including any error, misstatement, misleading statement, act, omission, neglect, or breach of duty committed, attempted, or allegedly committed or attempted by an officer or director of and . The policy also covers similar acts in relation to mergers and acquisitions. Moreover, the policy includes liability for pollution. The policy also provides direct and executive liability coverage for similar acts to and officers and directors.

Event Cancellation Insurance Policy provides indemnification to and for all losses resulting from the necessary cancellation, postponement, curtailment, or abandonment of any contracted scheduled events promoted by and , due to adverse weather, the discovery of pollutants, outbreak of disease, labor disputes, civil unrest, property damage to venues, non-appearance of artists, and government or civil authority requiring cancellation of such events.

The Special Risk – Expense Reimbursement Insurance Policy covers public relations expenses to mitigate adverse publicity to and under certain circumstances, including: actual or imminent incidents where the insureds potential liability amount is in excess of $; product recalls; layoffs and labor disputes; government or regulatory litigation; bankruptcy or other major financial crisis; loss of intellectual property rights; unsolicited takeover bids; terrorism; or any other adverse incident expected to reduce the insureds annual gross revenue by at least %. The policy also covers all expenses for and defenses to actual or alleged civil liability.

Form 886-A (Rev. January 1994)	EXPLANATIONS OF ITEMS		Schedule number or exhibit
Name of taxpayer		Tax Identification Number	Year/Period ended 12/31/20 12/31/20 12/24/20

Excess Intellectual Property Package Policy provides indemnification subject to certain limitations to and for all damages legally obligated to pay for litigation expenses, mitigation expenses, investigation expenses, costs to replace, restore, or re-create intellectual property, additional damages and rewards resulting from wrongful acts committed during the policy period. Wrongful acts include infringement of copyright, plagiarism, invasion or interference of right of privacy or publicity; libel; slander; piracy or unfair competition; breach of contract; patent infringement; and malicious prosecution with regard to intellectual property.

Special Risk – Loss of Major Business to Business Relationship Insurance Policy provides for the indemnification of and for any business interruption loss of up to 12 months suffered as a result of losing the services of and any other licensees. Business interruption includes the impact of lost revenue and the extra expenses involved in finding a replacement business to business relationship.

Special Risk – Loss of Services Insurance Policy provides for the indemnification of and for an involuntary loss of services of a key employee, , for sickness, disability, death, loss of license, termination of employment; resignation; retirement; or any other occurrence that deprives and from the receipt in a material and substantial way of his services.

Special Risk – Punitive Wrap Liability Insurance Policy provides that the taxpayer will pay claims filed by and , resulting from the failure of an insurer to cover punitive or exemplary damages, judgments, or awards, related to the other 9 policies, solely due to the enforcement of any law or judicial ruling that precludes the insuring of such damages and that but for such law or judicial ruling would otherwise be covered.

Special Risk – Regulatory Changes Insurance Policy covers actual compliance expenses and business interruptions suffered as a result of any regulatory change having an adverse impact on the normal on-going business operations of and . The policy does not cover adverse regulatory changes resulting from substantial noncompliance with regulations or guidelines or those changes initiated in direct response to negligent acts, omissions, or errors by and .

Special Risk – Tax Liability Insurance Policy provides and with indemnification up to % of the amount of additional tax liability each may incur on its 20 federal income tax return. No coverage is provided for additions to tax, civil penalties, or criminal penalties for delinquent returns or criminal or fraudulent acts.

In each contract, the taxpayer was listed as the "Lead Insurer" (%) and ( ) is listed as the "Stop Loss Insurer." With respect to the above direct written contracts, the taxpayer did not sale, write or issue separate policies to and . Each contract listed both parties, and , as the insured. The contracts also listed a single

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premium payment due to cover both parties. and did not pay separate premiums to the taxpayer in 20 and 20 . The taxpayer did not write direct contracts to unrelated third parties or the general public during 20 . With respect of each of the 10 above referenced property and casualty contracts, the taxpayer and (" ") entered into an agreement titled, "Joint Underwriting Stop Loss Endorsement." The taxpayer and are separate independent companies and are not owned and controlled by related parties. Nor is related to shareholders, directors, or officers of the taxpayer. Under the terms of the agreement, the taxpayer is responsible for payment of claims up to certain specified thresholds. If the specified thresholds are met, then becomes liable for payment of claims up to certain specified limits. If the specified limits for payment of claims are exceeded, then the taxpayer again becomes liable. Under each of the 10 direct-written contracts, the taxpayer received % of the total premiums, and received % of the total premiums. Page 5, paragraph 4 of the agreement reads as follows:

> The premium rate for this Joint Underwriting Stop Loss Endorsement is % of the combined gross direct written premiums for the specified policies due directly from the Insured(s). This endorsement premium of $ out of the total premiums of $ is payable directly from the Insured(s) to the Stop Loss Insurer.

Therefore, under the terms of the Joint Underwriting Stop Loss Endorsement agreement, and was required to pay of total premiums of $ for the ten direct written policies and for the stop loss endorsement. Of the total premiums, and paid $ directly to the taxpayer (%) as Lead Insurer. In addition, and paid $ as a reinsurance premium directly to , as the Stop Loss Insurer.

Based on the review of the contracts, the premiums paid by the Named Insureds under the terms of the 20 contracts was as follows:

Contracts	Total Premium	Portion of Premium To Taxpayer
1. Special Risk-Tax Liability	$	$
2. Special Risk-Punitive Wrap		
3. Special Risk-Regulatory Changes		
4. Excess Directors & Officers		
5. Special Risk Expense Reimbursement		
6. Special Risk Loss of Services		
7. Excess Intellectual Property Package		
8. Special Risk-Commercial General Liab.		
9. Event Cancellation		
10. Loss of Major Business to Business		
Totals	$	$

Form 886-A (Rev. January 1994)	EXPLANATIONS OF ITEMS	Schedule number or exhibit
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The taxpayer also entered into two types of reinsurance arrangements. The first arrangement is referred to as a "reinsurance risk pooling program." Under this arrangement, the taxpayer participated in a "reinsurance risk pool" with several other unrelated insurance companies ("pool participants"). The risk pool was operated by . Each pool participant had one or more affiliated operating entities for which it underwrites insurance coverage, generally casualty type coverage such as credit life and credit disability. insured a portion of the direct insurance underwritten by the pool participants using a so-called "stop loss" endorsement. participated in over insurance policies with more than insureds. blended together its direct written insurance and then reinsured the entire book on a quota share basis with each of the pool participants. According to the terms of the 20 Quota Share Reinsurance Policy executed with , the taxpayer was one of companies listed as reinsurer. As Reinsurer , the taxpayer retained % of a Quota Share Premiums from in exchange for the assumption of % of the risk pool comprised of the stop loss coverages issued during the policy period by to all stop loss endorsement policyholders. paid total reinsurance premiums of $ to Reinsurers. Of this total premium, the taxpayer received a quota share reinsurance premium equal to % or $, of which $ is the portion of the premium retained by taxpayer (as a quota share retained premium) until the final accounting and settlement of the Risk Pool was completed. The final accounting and settlement generally occurs 180 days following the expiration date shown in the Policy Declaration. The quota share retained premium was calculated at % of the quota share reinsurance policy premium of $. According to the general ledger, the taxpayer reported receiving a reinsurance premium of $ from in 20 .

Under the terms of the second arrangement, which is referred to as the , the taxpayer assumed reinsurance contracts from . The taxpayer reinsured a % quota share of the risks from vehicle service contracts reinsured by . The vehicle service contracts were initially written by in 20 , assumed by , then by from ; and finally assumed by . The taxpayer received a pro rata share (%) of the earned premiums received by . The taxpayer was paid a reinsurance premium of $ from in 20 .

Under the terms of the contracts reviewed for 20 , the taxpayer assumed risk exposures as follows:

Affiliated Interests	Direct exposure	%
Unrelated & Affiliate Interests	Pooled reinsurance exposure	
Unrelated Third Party	Pooled reinsurance exposure	
Total risk assumed		100.00%

Form 886-A (Rev. January 1994)	EXPLANATIONS OF ITEMS	Schedule number or exhibit
Name of taxpayer	Tax Identification Number	Year/Period ended 12/31/20 12/31/20 12/24/20

For the tax year ended December 31, 20 , the taxpayer reported gross receipts of $. Gross receipts were derived solely from premiums received from the direct written, reinsurance risk pooling program, and the credit coinsurance reinsurance program. The taxpayer received gross receipts as follows:

	20	
Program Revenue Service		
Direct Written Premiums	$	%
Quota Share Reinsurance Premiums		
Credit Coinsurance Reinsurance Premiums		
Total Premiums		100.00%
Investment Income		
Gain of sale of assets		
Other income		
Gross Receipts	$	100.00%

The December 31, 20 bank statement for its checking account with reflected three deposits totaling $. The statement reflected a deposit of $ on December 26, 20 , which represented the payment of insurance premiums received from for the ten direct written insurance policies. and did not pay separate premiums to the taxpayer for the direct written contracts. The premium payment received from represented the payment of the combined premium for both insured, , and . The other two deposits of $ each was made on December 24, 20 , and represented the initial contributions of capital by the two shareholders of the taxpayer

Of the total premiums received by the taxpayer in 20 , % of the premiums were generated from the ten direct written policies with the Affiliated Business Interests, and ; % of the premiums are from the ; and % of the premiums from the .

As of December 31, 20 , the taxpayer's assets totaled $, and consisted primarily of cash in its checking account of $.

20 Tax Year

The 20 tax year was the first full year of operations for the taxpayer. During the year, the taxpayer continued to operate as a captive company that insured certain property and casualty risks of affiliated business interests. The taxpayer participated in the same three programs

that it engaged in during the 20 tax year: (1) direct written contracts with affiliated business interests; (2) quota share risk pool reinsurance; (3) credit coinsurance reinsurance.

The taxpayer wrote six direct contracts to insure certain property and casualty risks of , and . The insureds are owned and controlled by the beneficial owners of the taxpayer, and .

The following direct written contracts were executed by the taxpayer with and in 20 :

Event Cancellation Insurance Policy provides indemnification to and for all losses resulting from the necessary cancellation, postponement, curtailment, or abandonment of any contracted scheduled events promoted by and , due to adverse weather, the discovery of pollutants, outbreak of disease, labor disputes, civil unrest, property damage to venues, non-appearance of artists, and government or civil authority requiring cancellation of such events.

Special Risk – Expense Reimbursement Insurance Policy covers public relations expenses to mitigate adverse publicity to and under certain circumstances, including: actual or imminent incidents where the insureds potential liability amount is in excess of $; product recalls; layoffs and labor disputes; government or regulatory litigation; bankruptcy or other major financial crisis; loss of intellectual property rights; unsolicited takeover bids; terrorism; or any other adverse incident expected to reduce the insureds annual gross revenue by at least %. The policy also covers all expenses for and defenses to actual or alleged civil liability.

Excess Intellectual Property Package Policy provides indemnification subject to certain limitations to and for all damages legally obligated to pay for litigation expenses, mitigation expenses, investigation expenses, costs to replace, restore, or re-create intellectual property, additional damages and rewards resulting from wrongful acts committed during the policy period. Wrongful acts include infringement of copyright, plagiarism, invasion or interference of right of privacy or publicity; libel; slander; piracy or unfair competition; breach of contract; patent infringement; and malicious prosecution with regard to intellectual property.

Special Risk – Expense Reimbursement – Legal Expenses Insurance Policy covers certain litigation expenses in excess of $ to mitigate costs to and , such as defense expenses; lost work time; cost to hire independent counsel; and expert witness fees and travel expenses.

Special Risk – Loss of Services Insurance Policy provides for the indemnification of and for an involuntary loss of services of a key employee, , for sickness,

disability, death, loss of license. termination of employment; resignation; retirement; or any other occurrence that deprives and from the receipt in a material and substantial way of his services.

Special Risk – Regulatory Changes Insurance Policy covers actual compliance expenses and business interruptions suffered as a result of any regulatory change having an adverse impact on the normal on-going business operations of and . The policy does not cover adverse regulatory changes resulting from substantial noncompliance with regulations or guidelines or those changes initiated in direct response to negligent acts, omissions, or errors by and .

In each contract, the taxpayer was listed as the "Lead Insurer" and is listed as the "Stop Loss Insurer." As Lead Insurer, the taxpayer assumed % of the risks under the direct written contracts. and the taxpayer executed a Joint Underwriting Stop Loss Endorsement, in which , as the Stop Loss Insurer, assumed the remaining % of the risks for four of the six direct written contracts: Event Cancellation, Excess Intellectual Property Package, Special Risk Loss of Services, and the Special Risks Regulatory Changes. The effective date of each contract is January 1, 20 , through January 1, 20 . Under the terms of each direct written contract, and , the affiliated business interests, are listed as the only insured parties. The taxpayer did not write or issue separate contracts to and .

The taxpayer received a direct written premium of $ from on December 30. 20 . The premium payment was deposited to the taxpayer's investment account with . The single premium payment covered both insured parties, and . Information Document Request #2 was issued to , CPA, on April 25, 20 . The CPA was asked to provide a breakdown of the direct written premiums paid by and . The CPA was also asked to provide a copy of any contract or agreement between and that addressed the allocation of the direct written premium attributable to and . In the August 20, 20 response, , CPA, stated that the company's records did not include information that shows the direct written premiums attributable to two insured entities, and .

With respect to each of the six property and casualty contracts written in 20 , the taxpayer and (" ") entered into an agreement titled, "Joint Underwriting Stop Loss Endorsement." Under the terms of the agreement, the taxpayer is responsible for payment of claims up to certain specified thresholds. If the specified thresholds are met, then becomes liable for payment of claims up to certain specified limits. If the specified limits for payment of claims are exceeded, then the taxpayer again becomes liable. Under each of the 6 direct-written contracts, the taxpayer received % of the total direct written premiums, and received % of the total direct written premiums.

Form 886-A (Rev. January 1994)	EXPLANATIONS OF ITEMS		Schedule number or exhibit
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Although page 5, paragraph 4 of the agreement reads as follows:

> The premium rate for this Joint Underwriting Stop Loss Endorsement is % of the combined gross direct written premiums for the specified policies due directly from the Insured(s). This endorsement premium of $ out of the total premiums of $ is payable directly from the Insured(s) to the Stop Loss Insurer.

Therefore, under the terms of the Joint Underwriting Stop Loss Endorsement agreement, and was required to pay of total premiums of $ for the six direct written policies and for the stop loss endorsement. Of the total premiums, and paid $ directly to the taxpayer (%) as Lead Insurer. In addition, and paid $ as a reinsurance premium directly to , as the Stop Loss Insurer.

Based on the review of the contracts, the premiums paid by the Named Insureds under the terms of the 20 contracts was as follows:

Contracts	Total Premium	Portion of Premium Due To Taxpayer
1. Special Risk-Regulatory Changes	$	$
2. Special Risk-Loss of Services		
3. Event Cancellation		
4. Excess Intellectual Property Package		
5. Expense Reimbursement		
6. Expense Reimbursement Legal Expense		
Totals		$

In addition to writing the direct contracts, the taxpayer continued to participate in the quota share risk pooling reinsurance agreement with . The risk pool was operated by an unaffiliated corporation, (" "), which is a regulated insurer. Each pool participant had one or more affiliated operating entities for which it underwrites casualty type insurance coverage, such that for calendar 20 writes a Stop Loss endorsement on 500± insurance policies covering more than 300± insureds. This includes policies issued by the taxpayer as well as those issued by the other pool participants that are unrelated insurance companies. As with the typical risk pooling arrangement, blended together its assumed risk coverages and then reinsured a quota share of these pooled risk with each of the pool participants. The end result of the pooling process was a more diversified book of risk coverages held by the taxpayer and by each of the other pool participants. According to the terms of the 20 Quota Share Reinsurance Policy executed with , the taxpayer was one of companies listed as reinsurer. As Reinsurer # the taxpayer retained % of a Quota Share Premiums from

Form **886-A** (Rev. January 1994)	**EXPLANATIONS OF ITEMS**		Schedule number or exhibit
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in exchange for the assumption of % of the risk pool comprised of the stop loss coverages issued during the policy period by to all stop loss endorsement policyholders. paid total reinsurance premiums of $ to Reinsurers. Of this total premium, the taxpayer received a quota share reinsurance premium equal to % or $, of which $ is the portion of the premium retained by taxpayer (as a quota share retained premium) until the final accounting and settlement of the was completed. The final accounting and settlement generally occurs 180 days following the expiration date shown in the Policy Declaration. The quota share retained premium was calculated at % of the quota share reinsurance policy premium of $. According to the general ledger, the taxpayer reported receiving a reinsurance premium of $ from in 20 .

Finally, the taxpayer continued to participate in the credit coinsurance reinsurance program with in 20 . The program involved the assumption of risks (that is, reinsurance assumed) from a third-party insurance company, which itself assumed such risks from other third party insurers, and which ultimately relates to a large pool of policies for vehicle service contracts that were directly written by a U.S. based insurance company, which served as the original ceding company. Under the terms of the contract, the taxpayer reinsured a % quota share of the risks from vehicle service contracts reinsured by . The vehicle service contracts were initially written by in 20 , assumed by , and finally assumed by from . The taxpayer was paid a reinsurance premium of $ from . Policies reinsured under the pooling arrangement ceded on a quota share basis provided reinsurance for property and casualty policies for or more unrelated insureds.

Under the terms of the contracts reviewed for 20 , the taxpayer assumed risk exposures as follows:

Direct Written Premiums	$	%
Quota Share Reinsurance Assumed		
Other Reinsurance Assumed		
Total	$	100.00%

The premium received by , for the six direct written contracts, accounted for approximately % of the total premiums received and risk assumed by the taxpayer in 20 . The Taxpayer did not write direct contracts with unrelated third parties or the general public during . For the tax year ended December 31, 20 the taxpayer reported gross receipts of $. Gross receipts were derived solely from premiums received from the direct written, reinsurance risk pooling program, and the credit coinsurance reinsurance program. The taxpayer received gross receipts as follows:

Form 886-A (Rev. January 1994)	EXPLANATIONS OF ITEMS	Schedule number or exhibit
Name of taxpayer	Tax Identification Number	Year/Period ended 12/31/20 12/31/20 12/24/20

	20	
Program Revenue Service		
Direct Written Premiums	$	
Quota Share Reinsurance Premiums		
Credit Coinsurance Reinsurance Premiums		
Total Premiums		%
Investment Income		
Gain of sale of assets		
Other income		
Gross Receipts	$	100.00%

The 20 bank statements for its checking account with reflected total deposits of $. for the year. The statements did not reflect deposit of direct written premium payments received by the taxpayer in 20 . During 20 , the taxpayer also opened an investment account with . The taxpayer deposited $ into the investment account, including a $ wire transfer from the account to the investment account.

The other two deposits of $ each was made on December 24, 20 , and represented the initial contributions of capital by the two shareholders of the taxpayer

Of the total premiums received by the taxpayer in 20 , % of the premiums were generated for the six direct written policies with the Affiliated Business Interests, and ; % of the premiums are from the ; and % of the premiums from the

20 Tax Year

The taxpayer filed Form 990-EZ for the short tax year ended December 24, 20 . In the heading of the return, Item, the taxpayer reported that it terminated the corporation. The Certificate of Dissolution, approved by the Registrar of Companies, Indies, on December 24, 20 , was attached to the Form 990-EZ. Books and records for the tax year ended December 31, 20 were not requested from the taxpayer.

The taxpayer did engage in similar activities in 20 , as those conducted in 20 and 20 , until the December 24, 20 , date of termination. In response to the preliminary report, Form 5701, *Notice of Proposed Adjustments*, issued on September 6, 20 , , CPA, indicated that prior to the date of termination, there was no substantial change in the activities of the taxpayer. On the 20 Form 990-EZ return, the taxpayer reported gross receipts and total income of $, of which $ was derived from premiums. Interest income of $ was the only other source of income reported on the return. Of the total premiums

received in 20 , $ was received from direct written contracts and $ was received from reinsurance contracts. The direct written premiums represented approximately % of the total premiums received and risk assumed by during the year.

As part of the termination and dissolution, the taxpayer equally distributed net assets totaling $, on December 23, 20 , to the following two shareholders:

(Partnership) $

(Individual) $

As of December 31, 20 , and December 31, 20 , the taxpayer's assets totaled $ and $, respectively, and consisted primarily of cash in the taxpayer's checking account and investment account. As of December 24, 20 , the taxpayer had no assets remaining because of the termination and distribution of the net assets to the shareholders.

With respect to the direct contracts insured in 20 , 20 and 20 , the taxpayer did not sale, write or issue separate policies to and . Each contract listed both parties, and , as the insured. The contracts also listed a single combined premium payment due to cover both parties. and did not pay separate premiums to the taxpayer in 20 and 20 . Nor did and have an agreement to show how the premium payments were to be allocated between them.

Based on the analysis of premiums received during the years under audit, two-thirds of the risks insured by the taxpayer was the risk from Affiliated Business Interests.

There is no evidence that the taxpayer engaged in any other activities or programs during the tax years ended December 31, 20 , and December 31, 20 .

LAW:

Section 501(c)(15) of the Internal Revenue Code provides insurance companies [as defined in section 816(a)] other than life (including inter-insurers and reciprocal underwriters) can qualify for tax-exempt status if:

Form 886-A (Rev. January 1994)	EXPLANATIONS OF ITEMS		Schedule number or exhibit
Name of taxpayer		Tax Identification Number	Year/Period ended 12/31/20 12/31/20 12/24/20

1. The gross receipts for the taxable year do not exceed $600,000, and more than 50% of such gross receipts consist of premiums, or

2. In the case of a mutual insurance company, the gross receipts of which for the taxable year do not exceed $150,000, and more than 35% of such gross receipts consist of premiums.

Section 831(c) defines the term "insurance company" for purposes of section 831, as having the same meaning as the terms is given under section 816(a). Section 816(a) provides that the term "insurance company" means any company more than half of the business of which during the taxable year is the issuing of insurance or annuity contracts or reinsuring of risks underwritten by insurance companies.

Pursuant to:

Helvering v. LeGierse, 312 U.S. 531 (1941), the United States Supreme Court in defining the term "insurance contract" held that in order for a contract to amount to an insurance contract, it must shift and distribute a risk of loss and that risk must be an "insurance" risk.

AMERCO, Inc. v. Commissioner, 979 F.2d 162, 164-65 (9th Cir. 1992), aff'g. 96 T.C. 18 (1991), "risk-shifting" means one party shifts his risk of loss to another, and "risk-distributing" means that the party assuming the risk distributes his potential liability, in part, among others. An arrangement without the elements of risk-shifting and risk-distributing lacks the fundamentals inherent in a true contract of insurance.

Allied Fidelity Corp. v. Commissioner, 572 F. 2d 1190, 1193 (7th Cir. 1978), the common definition for insurance is an agreement to protect the insured against a direct or indirect economic loss arising from a defined contingency whereby the insurer undertakes no present duty of   but stands ready to assume the financial burden of any covered loss.

Commissioner v. Treganowan, 183 F.2d 288, 290-91 (2d Cir. 1950), the risk must contemplate the fortuitous occurrence of a stated contingency.
Beech Aircraft Corp. v. United States, 797 F.2d 920, 922 (10th Cir. 1986), historically and commonly insurance involves risk –shifting and risk distributing. "Risk-shifting" means one party shifts his risk of loss to another, and "risk-distributing" means that the party assuming the risk distributes his potential liability, in part, among others. An arrangement without the elements of risk-shifting and risk-distributing lacks the fundamentals inherent in a true contract of insurance.

Ocean Drilling & Exploration Co. v. United States, 988 F.2d 1135, 1153 (Fed. Cir. 1993), for insurance purposes, "risk-shifting" means one party shifts his risk of loss to another, and "risk-distributing" means that the party assuming the risk distributes his potential liability, in part, among others.

Clougherty Packing Co. v. Commissioner, 811 F.2d 1297, 1300 (9th Cir. 1987), a true insurance agreement must remove the risk of loss from the insured party.

Humana, Inc. v. Commissioner, 881 F.2d 247, 257 (6th Cir. 1989), risk distribution involves shifting to a group of individuals the identified risk of the insured. The focus is broader and looks more to the insurer as to whether the risk insured against can be distributed over a larger group rather than the relationship between the insurer and any single insured.

Revenue Ruling 89-96, 1989-2 C.B. 114, an insurance agreement or contract must involve the requisite risk shifting necessary for insurance.

Revenue Ruling 2002-89, 2002-2 C.B. 984, it is not insurance where a parent company formed a subsidiary insurance company and 90% of the subsidiary's earned premium was paid by the parent company. The Rev. Rul. further held that such arrangement between a parent and a subsidiary would constitute insurance if less than 50% of the premium earned by the subsidiary is from the parent company.

Revenue Ruling 60-275, 1960-2 C.B. 43, risk shifting not present where subscribers, all subject to the same flood risk, agreed to coverage under a reciprocal flood insurance exchange.

Revenue Ruling 2002-90, 2002 C.B. 985, a wholly owned subsidiary that insured 12 subsidiaries of its parent constitute insurance for federal income tax purposes.

Revenue Ruling 2005-40, 2005-40 I.R.B. 4, an arrangement that purported to be an insurance contract but lacked the requisite risk distribution was characterized as a deposit arrangement, a loan, a contribution to capital, an indemnity arrangement that was not an insurance contract.

Revenue Ruling 2007-47, 2007-30 I.R.B. 127, an arrangement that provides for the reimbursement of inevitable future costs does not involve the requisite insurance risk.

Foreign Corporation Tax Provisions

IRC SEC. 951. AMOUNTS INCLUDED IN GROSS INCOME OF UNITED STATES SHAREHOLDERS.

951(a) AMOUNTS INCLUDED. —

(1) IN GENERAL. —If a foreign corporation is a controlled foreign corporation for an uninterrupted period of 30 days or more during any taxable year, every person who is a United States shareholder (as defined in subsection (b)) of such corporation and who owns (within the meaning of section 958(a)) stock in such corporation on the last day, in such year, on which

such corporation is a controlled foreign corporation shall include in his gross income, for his taxable year in which or with which such taxable year of the corporation ends —

(A) the sum of —

(i) his pro rata share (determined under paragraph (2)) of the corporation's subpart F income for such year,

(ii) his pro rata share (determined under section 955(a)(3) as in effect before the enactment of the Tax Reduction Act of 1975) of the corporation's previously excluded subpart F income withdrawn from investment in less developed countries for such year, and

(iii) his pro rata share (determined under section 955(a)(3)) of the corporation's previously excluded subpart F income withdrawn from foreign base company shipping operations for such year; and

IRC SEC. 953. INSURANCE INCOME.

953(a) INSURANCE INCOME. —

(1) IN GENERAL. —For purposes of section 952(a)(1), the term "insurance income" means any income which —

(A) is attributable to the issuing (or reinsuring) of an insurance or annuity contract, and

(B) would (subject to the modifications provided by subsection (b)) be taxed under subchapter L of this chapter if such income were the income of a domestic insurance company.

(2) EXCEPTION. —Such term shall not include any exempt insurance income (as defined in subsection (e)).

IRC SEC. 953. INSURANCE INCOME.

953(d) ELECTION BY FOREIGN INSURANCE COMPANY TO BE TREATED AS DOMESTIC CORPORATION.
(1) IN GENERAL. — If

(A) a foreign corporation is a controlled foreign corporation (as defined in section 957(a) by substituting "25 percent or more" for "more than 50 percent" and by using the definition of United States shareholder under 953(c)(1)(A)),

(B) such foreign corporation would qualify under part I or II of subchapter L for the taxable year if it were a domestic corporation,

(C) such foreign corporation meets such requirements as the Secretary shall prescribe to ensure that the taxes imposed by this chapter on such foreign corporation are paid, and

(D) such foreign corporation makes an election to have this paragraph apply and waives all benefits to such corporation granted by the United States under any treaty, for purposes of this title, such corporation shall be treated as a domestic corporation.

GOVERNMENT'S POSITION:

Form 1024 Application

The taxpayer filed a Form 1024 application on September 18, 20 , seeking retroactive exemption under IRC 501(c)(15), back to December 31, 20 , the date of incorporation. The application was ultimately withdrawn by , President, on September 16, 20 . The examining agent believes that the application was withdrawn by the company on the advice on its counsel, , , and , who are affiliated with , in . The examining agent believes the taxpayer was advised by its counsel to withdraw the Form 1024 application because counsel anticipated EO Rulings and Agreements would deny IRC 501(c)(15) tax-exempt status to , based on the position taken by Rulings and Agreements on applications filed by other clients of .

represented many captive insurance companies that filed Form 1024 applications seeking tax-exempt status under IRC 501(c)(15). All of the applications included basically identical fact patterns, and organizational and operational structure. However, after EO Rulings and Agreements received an adverse opinion from the IRS, Office of Chief Counsel, Financial Institutions & Products Division, concluding that the applicants were not insurance companies within the meaning of Subchapter L of the Code, because the contracts executed by the companies lack adequate risk distribution, Rulings and Agreements began issuing adverse denial letters to these companies. The remaining companies suddenly withdrew their Form 1024 applications, probably anticipating that their applications would also be denied tax-exempt status by EO Rulings and Agreements.

The examining agent believes that the withdrawals of the remaining applications, including the application filed by taxpayer, is more than mere coincidence. In addition, the examining agent believes the taxpayer withdrew its Form 1024 application upon advice from its counsel in order to avoid receiving an adverse denial letter from Rulings and Agreements.

Qualification as Insurance Company

Neither the Internal Revenue Code nor the Income Tax Regulations define the terms "insurance" or "insurance contract." The standard for evaluating whether an arrangement constitutes insurance for federal tax purposes has evolved over the years and is, at best, a nonexclusive facts and circumstances analysis. Sears, Roebuck and Co. v. Commissioner, 972 F.2d 858, 861-64 (7th Cir. 1992). The most frequently cited opinion on the definition of insurance is Helvering v. LeGierse, 312 U.S. 531 (1941), in which the Court describes "insurance" as an arrangement involving risk-shifting and risk-distributing of an actual "insurance risk" at the time the transaction was executed. Cases analyzing "captive insurance" arrangements have described the concept of "insurance" for federal income tax purposes as containing three elements: (1) involvement of an insurance risk; (2) shifting and distributing of that risk; and (3) insurance in its commonly accepted sense. See e.g., AMERCO, Inc. v. Commissioner, 979 F.2d 162, 164-65 (9th Cir. 1992), aff'g. 96 T.C. 18 (1991). The test, however, is not a rigid three-prong test.

There is also no single definition of insurance for non-tax purposes. "[T]he subject has no useful, or fixed definition. There is neither a universally accepted definition or concept of 'insurance' nor a [sic] exclusive concept or definition that can be persuasively applied in insurance lawyering." 1 APPLEMAN ON INSURANCE 2d, § 1.3 (2005). While "it seems appropriate that any concept and meaning of insurance be sufficiently broad and flexible to meet the varying and innovative transactions which humankind perpetually produces," care must be used to describe insurance because "overbroad definitions are not useful and may cause many commercial relationships erroneously to constitute insurance." Id. Moreover, a state's determination of whether a product is insurance for state law purposes does not control whether the product is insurance for federal tax law. See AMERCO, 96 T.C. 18, 41 (1991). There is no need for parity between a state law definition and federal definition as the objective for state purposes is company solvency. Solvency is not a concern for determining whether an arrangement qualifies as insurance for federal income tax purposes.

Not all contracts that transfer risk are insurance policies even where the primary purpose of the contract is to transfer risk. For example, a contract that protects against the failure to achieve a desired investment return protects against investment risk, not insurance risk. LeGierse, 312 U.S. at 542 (the risk must not be merely an investment risk); Securities and Exchange Commission v. United Benefit Life Insurance Co., 387 U.S. 202, 211 (1967) (the transfer of an investment risk cannot by itself create insurance). See also, Rev. Rul. 89-96, 1989-2 C.B. 114 (risks transferred were in the nature of investment risk, not insurance risk); Rev. Rul. 68-27,

1968-1 C.B. 315 (although an element of risk existed, it was predominantly a normal business risk of an organization engaged in furnishing medical services on a fixed price basis rather than an insurance risk) and Rev. Rul. 2007-47, 2007-2 C.B. 127 (the arrangement lacked the requisite insurance risk to constitute insurance because the arrangement lacked fortuity and the risk at issue was akin to the timing and investment risks of Rev. Rul. 89-96).

The line between investment risk and insurance risk, however, is pliable.

[t]he finance and insurance industries have much in common. The different tools these industries provide their customers for managing financial insurable risks rely on the same two fundamental concepts: risk pooling and risk transfer. Further, the valuation techniques in both financial and insurance markets are formally the same: the fair values of a security and an insurance policy are the discounted expected values of the cash flows they provide their owners. Scholars and practitioners recognize these commonalities. Not surprisingly the markets have converged recently; for example, some insurance companies offer mutual funds and life insurance tied to stock portfolios, and some banks sell annuities.
FINANCIAL ECONOMICS WITH APPLICATIONS TO INVESTMENTS, INSURANCE AND PENSIONS 1 (Harry H. Panler, ed., 2001).

Insurance risk requires a fortuitous event or hazard and not a mere timing or investment risk. A fortuitous event[1] (such as a fire or accident) is at the heart of any contract of insurance. See Commissioner v. Treganowan, 183 F.2d 288, 290-91 (2d Cir. 1950) (the risk must contemplate the fortuitous occurrence of a stated contingency not an expected event).

Lack of Insurance Risk

The Service analyzed the risk of the contracts to determine whether the contracts qualify as contracts of insurance, annuity contracts or reinsurance contracts: In deciding whether the contracts qualify as insurance contracts for federal tax purposes, we have considered all of the facts and circumstances associated with the parties in the context of the captive arrangement. When deciding that a specific contract is not insurance because it does not have an insurance risk but deals with a business or investment risk, we have considered such things as the ordinary activities of a business enterprise, the typical activities and obligations of running of a business, whether an action that might be covered by a policy is in the control of the insured within a business context, whether the economic risk involved is a market risk that is part of the

[1] A happening that, because it occurs only by chance or accident, the parties could not reasonably have foreseen. Black's Law Dictionary, 725 (9th ed. 2009). See also, First Restatement of Contracts § 291, cmt. a (1932); American Law Institute, Restatement (Second) Contracts § 379, cmt. a (1981). See Generally, Jeffery W. Stempel, Stempel on Insurance Contracts, § 1.06A[4] (2007 Supp.) ("[I]n the past 20 years, a "modern" view of fortuity as a matter of law has emerged in United States courts, one that largely embraces the notions of fortuity held by the American Law Institute when it adopted the Restatement of Contracts, first in 1932 and again in the Second Restatement published in 1981."

business environment, whether the insured is required by a law or regulation to pay for the covered claim, and whether the action is question is willful or inevitable.

20 Policies

1. Special Risk—Tax Liability Insurance Policy

Covers any additional tax liability up to $ subject to a deductible equal to % of the actual filed IRS tax liability provided return prepared and signed by CPA. Policy also covers defense expenses incurred in determining the final tax liability. Several IRS penalties are excluded from coverage.

Not insurance.

The policy is not insurance in the commonly accepted sense. There is no insurance risk but only investment or business risk.

2. Special Risk—Punitive Wrap Liability Insurance Policy

Covers claims for punitive or exemplary damages upon the failure of the insurer under policies listed that are issued to the insured to cover punitive or exemplary damages, judgments, or awards solely due t the enforcement of any law or judicial ruling that precludes the insuring of punitive or similar damages and that but for such law or ruling would otherwise be covered, and for which an insured is legally obligated to pay. The schedule of covered policies lists the other 9 direct written policies described in this part of this report.

Not insurance.

The policy is not insurance in the commonly accepted sense. There is no insurance risk but only investment or business risk.

3. Special Risk—Regulatory Changes Insurance Policy

Covers actual compliance expenses and any business interruption loss up to 12 months as a result of any regulatory change that has an adverse impact on insured's normal on-going business operations. Regulatory changes include governmental, administrative agency, or legislative changes, changes to environmental, zoning, transportation, or safety laws or regulations, changes to import/export laws, regulatory changes due to foreign political risk including the collapse of a foreign economy, and any regulatory change due to the insured's reorganization, such as changing from a corporation to a limited partnership. The policy excludes any claim for an adverse regulatory change due to the insured's substantial non-compliance with regulations or other guidelines.

Not insurance.

The policy is not insurance in the commonly accepted sense. There is no insurance risk but only investment or business risk.

4. Excess Directors & Officers Liability Insurance Policy

Covers wrongful acts or directors and officers.

Insurance.

5. Special Risk—Expense Reimbursement Insurance Policy

Coverage Form A deals with crisis management public relations expenses. This covers all public relations expenses to mitigate the insured's adverse publicity generated from an actual or imminent; liability incident that could exceed $; product recall; employee layoff or labor dispute; government litigation; financial crisis; loss of intellectual property rights; unsolicited takeover bid; security incident; or any incident expected to reduce annual gross revenue by at least %.

Coverage Form B deals with uninsured defense. This covers all defense expense for actual or alleged civil liability where there is no insurer to provide such coverage or where such coverage has been exhausted under an existing insurance contract.

Not insurance as to Coverage A. Coverage Form A is not insurance in the commonly accepted sense. There is no insurance risk but only investment or business risk.

We could not conclude that Coverage Form B is insurance in the commonly accepted sense. It is vague as to what liability/contract underlies the need for defense expenses.

6. Special Risk—Loss of Services Insurance Policy

Covers the involuntary loss of service for 2 employees. The covered cause of loss must be involuntary and includes sickness, disability, death, loss of license, resignation or retirement after 14 days. Coverage does not include any loss of services if the insured terminated the employment of the employee. Also excluded is any claim if the insured does not attempt to replace the employee timely. Claims costs can include costs incurred by existing employees, costs of temporary employees, training costs, and lost net revenue.

Not insurance.

Form 886-A (Rev. January 1994)	EXPLANATIONS OF ITEMS	Schedule number or exhibit
Name of taxpayer	Tax Identification Number	Year/Period ended 12/31/20 12/31/20 12/24/20

The policy is not insurance in the commonly accepted sense. Although a policy only covering death or disability of a key employee is insurance, the policy here covers many non-insurance risks, that is investment or business risks.

7. Excess Intellectual Property Package Policy

Insuring Agreement 1: Covers, damages, defense expenses, and compliance redesign expense for listed wrongful acts: infringement of copyrights, trademark etc; plagiarism or unauthorized use of ideas characters, plots etc; invasion of privacy or publicity; libel, slander, or product disparagement; piracy or unfair competition, misappropriation of advertising ideas, etc; breach of contract resulting from the alleged submission of material used by insured; patent infringement; malicious prosecution with regard to intellectual property. Compliance redesign expense covers expense to recall and/or redesign the insured's intellectual property to comply with a judgment or settlement. The policy excludes any intentional act by a director, officer or employee.

Insuring Agreement 2: Covers wrongful acts (listed above) committed by third parties against insured's intellectual property. It pays for litigation expenses, mitigation expense to mitigate the extent of the claim, costs to replace, restore, or re-create the covered intellectual property, and finally additional damages to the insured's business operations such as business interruption, loss of clients or market share, or public relations damage control efforts. The policy excludes loss due to insured's cyber presence.

Not insurance.

Insuring Agreement 1 and 2 are not insurance in the commonly accepted sense. There is no insurance risk but only investment or business risks. (It is not clear what intellectual property the insured possesses.)

8. Special Risk—Commercial General Liability (CGL) Gap Insurance Policy

This policy provides coverage for certain claims which are denied by , under General Liability Policy Number , effective August 31, 20 through August 31, 20 , as follows: (1) Knowing Violation of Rights of Others exclusion for Personal and Advertising Injury; (2) Limitations of Coverage to Designated Events; and (3) Abuse or Molestation Exclusion.

Not insurance.

We could not conclude that this contract is insurance in the commonly accepted sense. The contract is vague as to the underlying terms of the policy.

9. Event Cancellation Insurance Policy

This policy provides coverage for all losses resulting from the necessary cancellation, postponement, curtailment, or abandonment of any contracted scheduled event promoted by the insureds.

Insurance.

10. Loss of Major Business-to-Business Relationship Insurance Policy

This is business interruption insurance for the loss of a client.

Not insurance.

The policy is not insurance in the commonly accepted sense. There is no insurance risk but only investment or business risk.

20 Policies

1. Special Risk—Regulatory Changes Insurance Policy

Same as 20 . Not insurance.

2. Expense Reimbursement Insurance Policy

This policy differs from the 20 insurance policy with the same title. Covers losses in connection with crisis management public relations expenses.

Not insurance.

The policy is not insurance in the commonly accepted sense. There is no insurance risk but only investment or business risk.

3. Loss of Services Insurance Policy

Same as 20 . Not insurance.

4. Excess Intellectual Property Package Policy

Same as 20 . Not insurance.

5. Event Cancellation Insurance

Same as 20 . Insurance.

6. Expense Reimbursement—Legal Expenses Insurance Policy

New policy for 20 . Covers all litigation expenses incurred by the insured resulting for insured's actual or alleged civil liability.

Not insurance.

We could not conclude that this contract is insurance in the commonly accepted sense. The contract is vague as to what liability/contract underlies the need for defense expenses.

20 Policies.

The 20 contracts were not reviewed during the audit. In the Service's Preliminary Report, dated September 6, 20 , the taxpayer was asked if it operated in the same manner in 20 as it did during the 20 and 20 tax years, and if so, to submit any documentation to support changed in operations.

In its October 26, 20 response to the Preliminary Report, taxpayer did not submit any documentation indicating that its operations changed in 20 .

Thus, the Service contents that the taxpayer operated in the same manner in 20 , and thus, was not an insurance company for the 20 tax year because more than half of its business did not involve the issuance of insurance contracts or annuities or the reinsuring of risks underwritten by other insurance companies.

Other Insurance Policies

Quota Share Reinsurance Program.
participated in over insurance policies with more than insureds. blended together its direct written insurance and then reinsured the entire book on a quota share basis with each of the pool participants. As Reinsurer No. , in the 20 reinsurance program, Taxpayer received % of gross premiums of $, in exchange for the assumption % of the risk pool comprised of the stop loss coverage issued to all of the stop loss endorsement policyholders.

In 20 , participated in over insurance policies with more than insureds. blended together its direct written insurance and then reinsured the entire book on a quota share basis with each of the pool participants. As Reinsurer No. , Taxpayer received

Form 886-A (Rev. January 1994)	EXPLANATIONS OF ITEMS	Schedule number or exhibit
Name of taxpayer	Tax Identification Number	Year/Period ended 12/31/20 12/31/20 12/24/20

% of gross premiums of $, in exchange for the assumption of % of the risk pool comprised of the stop loss coverage issued to all of the stop loss endorsement policyholders.

We do not have any understanding of the risks insured by Taxpayer. We do not know whether the policies "reinsured" are similar to the several policies that we have concluded above are not insurance. However, the direct written contracts insured by do include the contracts written by . Therefore, it is highly likely that the entire pool, which is insured by and reinsured on a quota share basis with each of the pool participants, is primarily comprised of direct written contracts that the Service would deem not be insurance in the commonly accepted sense. Thus all or a portion of the premiums received by taxpayer, during the taxable years under consideration, would not be for reinsuring insurance risks.

Credit Coinsurance Reinsurance Program.

The policy reinsures risks on vehicle service contracts. Again, we do not know what risks are being insured and reinsured.

Pricing of Contracts

The Service also has concern about whether the premiums charged for the contracts were reasonable. A premium for an insurance contract is based on actuarial calculations and factors. Even if an insurance contract is deem to be "insurance" for federal tax purposes, the premium paid pursuant to that contract must be determined based on actuarial factors and principles. In the March 30, 20 response to IDR #1 for 20 , the CPA provided a copy of letters from ; ; and , which was purpose to address the method used for pricing the direct written and reinsurance contracts for the taxable years under consideration. However, the Service concluded that the letters did not address the method of pricing the specific direct written and reinsurance contracts that was a party to during 20 , 20 , and 20 . Thus, the Service concluded that the premiums received by taxpayer were not reasonable because they were not based on actuarial calculations and factors.

Risk Shifting

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 a payment from the insurer. See Rev. Rul. 60-275 (risk shifting not present where subscribers, all subject to the same flood risk, agreed to coverage under a reciprocal flood insurance exchange).

Risk Distribution

Risk distribution incorporates the statistical phenomenon known as the law of large numbers. The concept of risk distribution "emphasizes the pooling aspect of insurance: that it is the nature of an insurance contract to be part of a larger collection of coverages, combined to distribute risks between insureds." AMERCO and Subsidiaries v. Commissioner, 96 T.C. 18, 41 (1991), aff'd, 979 F.2d 162 (9th Cir. 1992). In Treganowan, 183 F.2d at 291, the court quoting Note, The New York Stock Exchange Gratuity Fund: Insurance That Isn't Insurance, 59 Yale L.J. 780, 784 (1950), explained that "by diffusing the risks through a mass of separate risk shifting contracts, the insurer casts his lot with the law of averages. The process of risk distribution, therefore, is the very essence of insurance." Also see Beech Aircraft Corp. v United States, 797, F.2d 920, 922 (10th Cir. 1986), (risk distribution "means that the party assuming the risk distributes his potential liability, in part, among others"); Ocean Drilling & Exploration Co. v. United States, 988 F.2d 1135, 1135 (Fed. Cir. 1993) ("risk distribution involves spreading the risk of loss among policyholders").

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 over time, the insurer smoothes out losses to match more closely its receipts 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).

In Situation 1 of Rev. Rul. 2002-89, S, a wholly owned subsidiary of P, a domestic parent corporation, entered into an annual arrangement with P whereby S provided coverage for P's professional liability risks. The liability coverage S provided to P accounted for 90% of the total risks borne by S. Under the facts of Situation 1, the Service concluded that insurance did not exist for federal income tax purposes. On the other hand, in Situation 2 of Rev. Rul. 2002-89, the premiums that S received from the arrangement with P constituted less than 50% of total premiums received by S for the year. Under the facts of Situation 2, the Service reasoned that the premiums and risks of P were pooled with those of unrelated insureds and thus the requisite risk shifting and risk distribution were present. Accordingly, under Situation 2, the arrangement between P and S constituted insurance for federal income tax purposes.

In Rev. Rul. 2002-90, S, a wholly owned insurance subsidiary of P, directly insured the professional liability risks of 12 operating subsidiaries of its parent. S was adequately capitalized and there were no related guarantees of any kind in favor of S. Most importantly, S and the insured operating subsidiaries conducted themselves in a manner consistent with the standards applicable to an insurance arrangement between unrelated parties. Together, the 12 operating subsidiaries had a significant volume of independent, homogeneous risks. Under the facts presented, the ruling concludes the arrangement between S and each of the 12 operating subsidiaries of the parent of S constitute insurance for federal income tax purposes.

Situation 1 of Rev. Rul. 2005-40, describes a scenario where a domestic corporation operated a large fleet of automotive vehicles in its courier transport business covering a large portion of the United States. This represented a significant volume of independent, homogeneous risks. For valid non-tax business purposes, the transport company entered into an insurance arrangement with an unrelated domestic corporation, whereby in exchange for an agreed amount of "premiums," the domestic carrier "insured" the transport company against the risk of loss arising out of the operation of its fleet in the conduct of its courier business. The unrelated carrier received arm's length premiums, was adequately capitalized, received no guarantees from the courier transport company and was not involved in any loans of funds back to the transport company. The transport company was the carrier's only "insured." While the requisite risk-shifting was seemingly present, the risks assumed by the carrier were not distributed among other insured's or policyholders. Therefore, the arrangement between the carrier and the transport company did not constitute insurance for federal income tax purposes.

The facts in Situation 2 of Rev. Ruling 2005-40 mirror the facts of Situation 1 except that in addition to its arrangement with the transport company, the carrier entered into a second arrangement with another unrelated domestic company. In the second arrangement, the carrier agreed that in exchange for "premiums," it would "insure" the second company against its risk of loss associated with the operation of its own transport fleet. The amount that the carrier received from the second agreement constituted 10% of the total amounts it received during the tax year on a gross and net basis. Thus, 90% of the carrier's business remained with one insured. The revenue ruling concluded that the first arrangement still lacked the requisite risk distribution to constitute insurance even though the scenario involved multiple insureds.

In Situation 4 of Rev. Rul. 2005-40, 12 LLC's elected classification as associations, each contributing between 5 and 15% of the insurer's total risks. The Service concluded that this transaction constituted insurance for federal income tax purposes.

The principal concern with regard to your activities is whether there is sufficient risk distribution. As discussed above, the idea of risk distribution involves some mathematical concepts. For example, risk distribution is said to incorporate the statistical phenomenon known as the "law of large numbers" whereby distributing risks allows the insurer to reduce the possibility that a single costly claim will exceed the amount taken in as premiums. The concept hinges on the assumption of "numerous relatively small" and "independent risks" that "occur randomly over time." Clougherty Packing Co., 811 F.2d 1297 at 1300.

As discussed, the Service in Rev. Rul. 2002-90, concluded that insurance existed where 12 insureds each contributed between five and 15% to the insured's total risks. Similarly, in Situation 4 of Rev. Rul. 2005-40, the Service concluded that insurance existed where 12 LLCs, electing classification as associations, each contributed between five and 15% of the insurer's

total risks. Moreover, in Situation 2 of Rev. Rul. 2002-89, supra, the Service concluded that insurance existed where a wholly owned subsidiary insured its parent, but the arrangement represented less than 50% of the insurer's total risk for the year.

In the instance case, the facts therein are analogous to the analysis under Situation1 of Rev. Rul. 2002-89, supra, the liability coverage provided to the parent corporation by its wholly owned subsidiary accounted for 90% of the total risks borne by the subsidiary. Similarly, in Situation 2 of Rev. Rul. 2005-40, supra, a second insurer contributing 10% of the insured's risks was added to the single-insured scenario of Situation1. The Service concluded in both of the above scenarios that insurance did not exist because there lacked a sufficient number of insureds. The small number of insureds produced an insufficient pool of premiums to distribute any insurance risk."

The current position of the Service with respect to captive insurance arrangements is expressed in Revenue Ruling 2005-40. In Situation 2 of the ruling, the Service concluded that insurance did not exist because the captive arrangement with a single-insured lacked risk distribution. However, in Situation 4, the Service concluded that the captive arrangement with 12 LLC's did result in insurance. The main point of Revenue Ruling 2005-40, Situations 2 and 4, is the Service established a range between a single-insured and twelve-insured entities that might or might not meet the requisite risk distribution needed to qualify as insurance. The closer the number of insured parties in the captive arrangement approaches 12 insured, the more likelihood adequate risk distribution exist, and the arrangement will qualify as insurance. However, the closer the number of insured parties in the captive arrangement approaches one insured, the more likelihood the arrangement lacks adequate risk distribution and will not qualify as insurance.

With respect to the contracts reviewed during the tax years under audit, the Service concluded that the agreements between the taxpayer and and , the insureds, do not constitute contracts of insurance because they lack the essential element of risk distribution. Most of the risk insured by the taxpayer is under the direct written contracts with affiliated businesses. The affiliated businesses are owned by the beneficial owners, and . Of total risk insured by the taxpayer, approximately % percent of the risk assumed during the years under audit is that of the affiliated businesses.[2] In addition, of the total premiums received during the year, % percent of the premiums were derived from the direct written contracts that insure the risk of the affiliated business. Approximately % of all premiums and % of the direct written premiums were paid by a single entity, , even though the direct contracts covered two related insured. did not write or issue separate contracts to the affiliated insured. Nor did the two affiliated businesses make separate premium payments to the taxpayer. In affect, the direct written contracts were sold to

[2] Average of risk assumed in 20 and 20 (% + % = divided by 2 years = %)

a single affiliated entity, , but covered both affiliated businesses. Even if the affiliated insured did pay separate premiums to the taxpayer, this still would not create a pool large enough to adequately distribute insurance risk. Rev. Rul. 2005-40 cited several court decisions that have recognized that risk distribution necessarily entails a pooling of premiums, so that a potential insured is not in significant part paying for its own risks. In this case, the large concentration of insurance risks in one insured does not constitute risk distribution because of the very high likelihood of the insured paying for any of its claims with its own premiums. Such an arrangement is not insurance but a form of self-insurance.

The Service concluded that the contracts resulted in risk that was too heavily concentrated in a single policyholder, , insuring the two affiliated business interests. Because the risk was heavily concentrated in the Affiliated Businesses, it is highly probable that any losses paid by the taxpayer are those of the Affiliated Businesses and not from an unrelated third party. In addition, since the Affiliated Businesses paid the majority of premiums received by the taxpayer during the years under audit, the Service concluded that losses incurred by the Affiliated Businesses were paid from the premiums paid to the taxpayer by the Affiliated Businesses. In other words, the arrangement between the taxpayer and the Affiliated Businesses represented a form of self-insurance, and no court has held that self-insurance is insurance for federal tax purposes.

Also, an arrangement that provides for the reimbursement of believed-to-be inevitable future costs does not involve the requisite insurance risk for purposes of determining whether the assuming entity may account for the arrangement as an "insurance contract" for purposes of Subchapter L of the Internal Revenue Code.

Assuming that all of the agreements do constitute insurable risks or that a significant majority of the contracts qualify as insurable risks, over % of the total risks assumed by the company are with affiliated entities that are owned and controlled by and , beneficial owners of The taxpayer

Gross Receipts Test

Section 501(c)(15) of the Internal Revenue Code provides exemptions for insurance companies, other than life insurance companies (including inter-insurers and reciprocal underwriters), if the gross receipts for the taxable year do not exceed $600,000, and more than 50% of such gross receipts consist of premiums.

Based the Service's analysis of the contracts, nine of the twelve direct written contracts were deemed not to be insurance (or we could definitively determine whether the contract included an insurance risk). Therefore, the amounts received by for those nine direct written contracts are not considered insurance premiums. Amounts received by taxpayer for three of the twelve direct written contracts were deemed to be premiums because only for those contracts included an insurance risk.

Form 886-A (Rev. January 1994)	EXPLANATIONS OF ITEMS	Schedule number or exhibit
Name of taxpayer	Tax Identification Number	Year/Period ended 12/31/20 12/31/20 12/24/20

During the taxable years under consideration, received amounts that the Service deemed to be direct written and reinsurance premiums as follows:

20

Contract	Premium
Excess Directors & Officers Liability	$
Event Cancellation	
Amount Deemed Premiums from Direct Written Contracts	$
Quota Share Premiums	
Credit Coinsurance Reinsurance	
Total Premiums for 20	$
Gross Receipts for 20	
Percentage of Premiums to Gross Receipts	%

20

Contract	Premium
Event Cancellation	
Amount Deemed Premiums from Direct Written Contracts	$
Quota Share Premiums	
Credit Coinsurance Reinsurance	
Total Premiums for 20	$
Gross Receipts for 20	$
Percentage of Premiums to Gross Receipts	%

For 20 , no analysis of the gross receipts computation was completed by the Service because the policies and financial records were not reviewed.

The amounts received by under the remaining direct written contracts were not premiums for insurance contracts in the commonly accepted sense. The terms of the contracts did not include insurance risk but covered investment or business risks. The remaining contracts lacked the requisite insurance risk to constitute insurance because the contracts lacked fortuity, and the risk at issue is akin to the timing and investment risks of Rev. Rul. 89-96.

An arrangement that provides for the reimbursement of believed-to-be inevitable future costs does not involve the requisite insurance risk for purposes of determining whether the assuming entity may account for the arrangement as an "insurance contract" for purposes of Subchapter L of the Internal Revenue Code. For the contracts that are deemed not to qualify as insurable risks, then the amount paid for each contract, by would not qualify as an insurance premium.

Form 886-A (Rev. January 1994)	EXPLANATIONS OF ITEMS		Schedule number or exhibit
Name of taxpayer		Tax Identification Number	Year/Period ended 12/31/20 12/31/20 12/24/20

In addition, although we question whether the Quota Share contracts are actually valid reinsurance contracts, and whether the amounts received by taxpayer under the contracts are valid reinsurance premiums, the amounts received by taxpayer from were included as "premium income" for purposes of the gross receipts computation shown above. Even after given the taxpayer the benefit of the doubt, the taxpayer still failed the gross receipts for the years under audit.

Although gross receipts were less than the $600,000 for the 20 and 20 tax years, the amounts deemed to be premiums were more than 50% of gross receipts for the 20 tax year only. Premiums were not more the 50% of gross receipts for 20 . Therefore, we are revising our position on the gross receipts test as stated in our Preliminary Report issued to taxpayer on September 6, 20 . Based on further analysis of the contracts, we concluded that the taxpayer did not meet the 50% gross receipts test described in IRC 501(c)(15) and Notice 2006-42 for the 20 tax year, but did meet the gross receipts test for 20 .

As described in Situation 1 of Rev. Rul. 2002-89, supra, and Situation 2 of Rev. Rul. 2005-40, supra, there exists an inadequate premium pooling base for insurance to exist. The addition of the two other reinsurance arrangements does not change the conclusion that the agreements with and lacks risk distribution. Therefore, the taxpayer does not qualify as an insurance company.

A Preliminary Report, Form 5701, *Notice of Proposed Adjustments*, was mailed to the taxpayer's CPA, , on September 6, 20 , proposing denial of tax-exempt treatment under section 501(c)(15) of the Internal Revenue Code, for the tax years ending December 31, 20 , December 31, 20 , and December 31, 20 .

TAXPAYER'S POSITION:

A response to the Preliminary Report was received from , CPA, on October 26, 20 . In the response, the CPA summarized that the taxpayer disagreed with the Service's conclusion that the contracts issued by lack adequate risk distribution, and that primary and predominant business is insurance; qualifies for IRC 501(c)(15) tax-exempt status; and is not a controlled foreign corporation. The CPA argued the following points:

1. The audit of appears to be outcome determinative as evidenced by the fact that records for the 20 tax year were not even reviewed prior to the insurance of the proposed adjustment.
2. In reaching its incorrect conclusion that insurance operations lacked the requisite risk distribution, the Service ignored more than thirty years of well-

established tax law, as well as hundreds of prior favorable rulings issued by the Service.

3. The taxpayer indicated that "in analyzing captive insurance arrangements for the presence of risk distribution, courts have looked at the level of unrelated risk as a metric for the presence of risk distribution." The Service ignores the Tax Court ruling in *The Harper Group and Includible Subs. v Commissioner*, 96, T.C. 45 (1991), aff'd979 F.2d 1342 (9th Cir. 1992), where 30% unrelated risks was determined to be sufficient to meet the risk distribution requirement.

4. The taxpayer stated that the Service conducted no meaningful examination of risk distribution in its audit of Rather, the Service simply claims that the direct written contracts lack the requisite risk distribution. The nature of insurance is the number of underlying risk exposures present, not an artificial entity count or an artificial count of the number of policies written. The Taxpayer cites *AMERCO, Inc. v. Commissioner*, No. 91-70732, slip op. 13187 (9th Cir. Nov. 5, 1992).

5. The taxpayer argues that the 30% outside business principle and the decision in *Harper* are recognized in the Service's own Foreign Insurance Excise Tax Audit Technique Guide.

6. The Service appears to ignore Revenue Ruling 2001-31, in which the Service conceded that it would no longer assert the economic family theory due to its rejection by the courts.

7. The taxpayer argues risk distribution can occur even with a single insured. The taxpayer cited, *Malone & Hyde v. Commissioner.*

8. Rather than engage in a meaningful analysis of the number of independent risk exposures insured by the Service merely asserts that risk distribution is lacking. The Service has recognized the principle of looking-through the insurance policy to the actual risks insured in several revenue rulings. See Rev. Rul. 2009-26, Rev. Rul. 92-93, and Rev. Rul. 80-95.

9. Taxpayer argues the Service's current position is directly contrary to the position it has taken in hundreds of prior Section 501(c)(15) tax-exempt determination letters that it has issued. These favorable rulings were issued to taxpayer on substantially similar, or less favorable, facts to those of There has been no intervening change in law to account for the Service's disparate tax treatment between and such similarly situated taxpayers. Accordingly, the Service has violated its own procedures and mandate to provide a uniform application of existing tax law (Rev. Proc. 2012-9).

Form **886-A** (Rev. January 1994)	**EXPLANATIONS OF ITEMS**		Schedule number or exhibit
Name of taxpayer		Tax Identification Number	Year/Period ended 12/31/20 12/31/20 12/24/20

10. Taxpayer argues that it qualifies for tax-exempt status as an insurance company described in IRC 501(c)(15) during all of the years under review. Taxpayer made a valid election under IRC Section 953(d) to be treated as a domestic corporation, and the Service's conclusion that the taxpayer is a controlled foreign corporation is incorrect.

Government's Response to Taxpayer's Position:

After reviewing the response to the Preliminary Report received from , CPA, on September 6, 20 , the Service's initial position is unchanged. s primary and predominant business in tax years 20 , 20 , and 20 , was not insurance because the contracts issued by the company lacked the requisite risk distribution.

Taxpayer's Position:

In the initial paragraph of the October 16, 20 response to the agent's preliminary report, the CPA stated that the audit of appear to be outcome determinative as evidenced by the fact that records for the 20 tax year were not even reviewed prior to the issuance of the proposed adjustment.

Government's Response:

The outcome of the examination was not outcome determinative even though the books and records for the 20 tax year were not examined. The examining agent did examine the books and records for the 20 and 20 tax years. During the examination, the examining agent also inspected the Form 990-EZ return filed by the taxpayer for the 20 tax years. The examining agent concluded that the only significant change in operations was the dissolution of the taxpayer on December 24, 20 . Between the period of January 1, 20 , through December 23, 20 , the taxpayer conducted the same business in the same manner as in 20 and 20 . Therefore, the examining agent concluded that examining the 20 books and records was not necessary.

In addition, on three page of the Preliminary Report, dated September 6, 20 , the CPA was given an opportunity to provide any information that might show that the taxpayer's operations were significantly different in 20 , than those conducted in 20 and 20 The CPA did not provide any information to support his position.

Taxpayer's Position:

On page 2 of the Taxpayer's position, the CPA cites the *Harper Group & Subsidiaries v. Commissioner*, 96 T.C. 45 (1991) to support the argument that qualifies as an insurance company. The CPA sites the court's holding, when a significant percentage (percent) of an insurance company's income is received from a relatively large number of unrelated insureds, the requirement of risk distribution is satisfied. The source of

Form 886-A (Rev. January 1994)	EXPLANATIONS OF ITEMS	Schedule number or exhibit
Name of taxpayer	Tax Identification Number	Year/Period ended 12/31/20 12/31/20 12/24/20

the remaining percent is irrelevant on the issue whether sufficient risk distribution is present because of the significant presence of unrelated risks. The CPA made the following statement in paragraph 2 on page 2 of the September 6, 20 response:

> In its preliminary report, the Service merely states, that due to percent of premiums being direct written premiums paid by certain insureds that owned no interest in there is a lack of adequate risk distribution. This ignores the fact that more than percent of premiums were attributable to unrelated insurance arrangements involving many thousands of independent, unrelated risks of hundreds or thousands of unrelated insureds.

Government's Response:

The Service disagrees with the CPA's assertion that the determining factor of whether the requisite risk distribution is present is identifying the percentage of business with unrelated insureds. Instead, the current Service's position on captive insurance arrangements is expressed in Revenue Ruling 2005-40, which emphasizes the number of policyholders and percentage of business with the related or affiliated insureds as the determining factor of whether risk distribution is present. The Rev. Rul. emphasizes that an arrangement where an issuer received premiums from a single policyholder lacks the requisite risk distribution. The ruling further emphasized that an issuer with contracts with a small number of policyholders can be insurance if the percentage of business exceeds 50 percent of the total insurance business conducted.

Even if the CPA claimed that insurance exists under the rationale in the Harper case, where approximately % of the risk assumed by was from unrelated or unaffiliated insureds, the Service believes that this conclusion would be based on a misunderstanding of the Harper Case. In the Harper Case, 67% to 71% of the total premiums received for the years at issue were not related to a single policyholder. Rather, the 67% to 71% were the total percentages received from all related policyholders, including brother-sister corporations (a total of 13 entities). The court's analysis in Harper Group must be read in its entirety and all the facts and circumstances must be considered, i.e. that there are 13 entities making up the nearly two thirds risk concentration in all the years at issue.

The Service's interpretation of the Harper Group is consistent with the conclusions reached by the Service in Situation 2 of Revenue Ruling 2002-89 and Situation 4 of Revenue Ruling 2005-40.

Form 886-A (Rev. January 1994)	EXPLANATIONS OF ITEMS	Schedule number or exhibit
Name of taxpayer	Tax Identification Number	Year/Period ended 12/31/20 12/31/20 12/24/20

Taxpayer's Position:

On page 3, paragraph 1, of the taxpayer's position, the CPA stated that the Service conducted no meaningful examination of risk distribution in its audit of Rather, the Service simply claims that the direct written contracts lack the requisite risk distribution. The nature of insurance is the number of underlying risk exposures present, not an artificial entity count or an artificial count of the number of policies written.

Government's Response:

In Question 10, of IDR #2, issued to CPA on March, 9, 20 , an analysis of risk assumed by the taxpayer was presented by the examining agent to the CPA for comment.

Under the terms of the contracts reviewed during the audit, assumed risk exposures as follows:

Affiliated Business Interests	Direct exposure	%	%
Unrelated & Affiliate Interests	Pooled reinsurance exposure		
Unrelated & Affiliate Interests	Pooled reinsurance exposure		
Total risk assumed		%	100.00%

In the June 20, 20 response to IDR #2, , CPA, provided the following comments:

> The percentages listed in your question are incorrect. The percentages were derived from simply adding together the company's participation rates in various direct insurance and reinsurance contracts. This method does not take into account relative value of the different contracts and is, therefore, invalid. The proper method for determining the amount of risk being assumed by the company is to compare the premiums received on the various contracts. The Income Statement included under Tab 17 of the initial IDR response shows the following:

20		
Direct Written Premiums	$	%
Other Reinsurance Assumed		%
Pooled Reinsurance Assumed		%
Total	$	100.00%

20		
Direct Written Premiums	$	%
Other Reinsurance Assumed		%
Pooled Reinsurance Assumed		%
Total	$	100.00%

20		
Direct Written Premiums	$	%
Reinsurance premiums		%
Total	$	100.00%

Based on the CPA's own statement, **the proper way to determine the percentage of risk assumed by the taxpayer is to compare the premium income received under the contracts issued.** Using this method, the Service concluded that the taxpayer's the primary and predominant activity conducted is assuming risk under the direct written contracts with the affiliated business interests, because the activity accounted for more than percent of the business (and premiums) during the three years under audit..

Taxpayer's Position:

On page 4, paragraph 1, the CPA stated that in reaching its incorrect conclusion in the preliminary report, the Service appears to ignore Revenue Ruling 2001-31, in which the Service conceded that it would no longer assert the economic family theory due to its rejection by the courts.

Government's Response:

The current Service position is expressed in Ruling Revenue 2005-40, I.R.B. 2005-27 (June 17, 2005), which provides IRS issued guidance emphasizing that the requirement of risk distribution must be met. The ruling demonstrated that this risk distribution requirement cannot be satisfied if the issuer of the contract enters into such a contract with only one policyholder. If the contract fails to constitute insurance, then the premiums paid are not deductible business expenses under Code Sec. 162, and the issuing company is not an insurance company for federal tax purposes. Rev. Rul. 2005-40 cited several court decisions that have recognized that risk distribution necessarily entails a pooling of premiums, so that a potential insured is not in significant part paying for its own risks. In this case, the large concentration of insurance risks in one insured does not constitute risk distribution because of the very high likelihood of the insured paying for any of its claims with its own premiums. Such an arrangement is not insurance but a form of self-insurance.

However, when the arrangements between the companies do constitute insurance for federal income tax purposes and assuming these arrangements represented more than percent of the insuring company's business, the company will be an insurance company within the meaning of IRC Sections 816 and 831, and the premium payments may be deductible under Code Sec. 162, assuming the requirements for deduction are otherwise satisfied

Taxpayer's Position:

On page 4, paragraph 4, the CPA stated that the Service's position is directly contrary to the position it has taken in hundreds of prior Section 501(c)(15) tax-exempt determination letters

that it has issued. These favorable determination letters were issued to taxpayers substantially similar, or less favorable, facts to those of There has been no intervening change in law to account for the Service's disparate tax treatment between and such similarly situated taxpayers. Accordingly, the Service has violated its own procedures and mandate to provide a uniform application of existing tax law. See Rev. Rul. 2012-9, Section 9.

Government's Response:

The Service's current position on captive arrangements is expressed in Revenue Ruling 2005-40, I.R.B. 2005-27 (June 17, 2005). Although the service has issued favorable rulings to similar captive arrangements in the past, many of the rulings were issued prior to the publishing of Revenue Ruling 2005-40, and clarification of the revenue ruling received from the Office of Chief Counsel.

In addition, the Service is not precluded from proposing denial of IRC 501(c)(15) tax-exempt status to simply because the Service issued favorable ruling letters to other applicants in the past.

Furthermore, the Service was not provided adequate opportunity to rule on the taxpayer's Form 1024 application filed with Rulings & Agreements in September 20 , because the taxpayer withdrew the application, in September 20 , before a final determination could be made by the Service.

Taxpayer's Position:

In paragraph 2 on page 5, the CPA stated that qualified for tax-exempt status as an insurance company described in IRC Section 501(c)(15) during all of the years under review. As made a valid election under IRC Section 953(d) to be treated as a domestic corporation, the Service's conclusion that is a controlled foreign corporation is incorrect.

Government's Response:

According to the Form 1024, Application for Recognition of Tax-Exempt Status, administrative file, the taxpayer filed its IRC 953(d) election with the office of the Service on February 23, 20 .

IRS records reveal that the IRC 953(d) election was not approved by the Service because the taxpayer did not submit proof of IRC 501(c)(15) tax-exempt status. The taxpayer could not provide proof of IRC 501(c)(15) tax-exempt status because it did not complete the Form 1024 application process. The taxpayer withdrew its Form 1024 application on September 16, 20 , after its Counsel anticipated that the Service would issue a final adverse ruling letter denying IRC 501(c)(15) exemption.

Form 886-A (Rev. January 1994)	EXPLANATIONS OF ITEMS	Schedule number or exhibit
Name of taxpayer	Tax Identification Number	Year/Period ended 12/31/20 12/31/20 12/24/20

IRC 953(d) allows foreign insurance company to elect to be treated as a domestic company for tax purposes if it meets certain requirements. One such requirement is that the foreign company must be a company that would qualify as an insurance company, under part I or II of subchapter L, for the taxable year if it were a domestic corporation. See IRC 953(d)(1)(B).

Since the Service determined that the taxpayer is not an insurance company within the meaning of Subchapter L of the Code for the year under audit, it fails to meet the requirements for the election under IRC 953(d) to be treated as a domestic corporation.

In addition, because the taxpayer does not meet the requirements to make the IRC 953(d) election, and thus, is not a domestic corporation, the taxpayer should be treated as a "controlled foreign corporation," and the provisions of Subpart F of the Internal Revenue Code (sections 951-965) should apply.

CONCLUSION:

Because taxpayer did not qualify as an insurance company for federal income tax purposes, taxpayer failed to meet the requirements of section 501(c)(15) of the Code. Thus, taxpayer did not qualify for recognition of exemption under section 501(a) of the Code as an organization described in section 501(c)(15) of the Internal Revenue Code for the tax years ended December 31, 20 , December 31, 20 , and December 24, 20 .

Since the IRC 953(d) election filed by taxpayer was not been approved by the IRS, the taxpayer should be treated as a controlled foreign corporation, and the subpart F provisions should apply.