

**Internal Revenue Service
Appeals Office**

Department of the Treasury

Employer Identification Number:

Release Number: 201712013

Release Date: 3/24/2017

Date: September 26, 2016

ORG
ADDRESS

Person to Contact:

Employee ID Number:

Tel:

Fax:

Tax Period(s) Ended:

December 31, 20XX

December 31, 20XX

December 31, 20XX

December 31, 20XX

Certified Mail

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 (Form 1120, Form 1041 or Form 1120-F for foreign corporations) 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

TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

Date: September 3, 2013

Taxpayer Identification Number:

**ORG
ADDRESS**

Form:

990-EZ / 990

Tax Period(s) Ended:

12/31/20XX; 12/31/20XX;

12/31/20XX; 12/31/20XX

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 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. 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 12/31/20XX 12/31/20XX 12/31/20XX 12/31/20XX

ISSUES:

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 the IRC 953(d) election valid if the taxpayer is not an insurance company, and the election was never approved by the Service?

FACTS:

____ (“Taxpayer”) was formed and incorporated in _____ on December 28, 20XX, 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 0 common shares with a \$0 par value. The taxpayer actually issued 0 shares in consideration of \$0 capital contribution.

The taxpayer is wholly owned by _____, a State limited liability company, located at _____, as the sole shareholder, purchased 0 shares of the taxpayer’s stock for \$0, on December 29, 20XX. _____ is owned by _____ (0%) and _____ (0%), husband and wife. Both individuals are U.S. citizens, who reside in _____.

The TEGE examining agent obtained a copy of taxpayer’s Form 1024 application administrative file from Rulings and Agreements in Washington D. C., on October 29, 20XX. 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 20XX and subsequent years; forms of credit reinsurance agreements entered into by the taxpayer; and a copy of the 20XX insurance policies issued by the taxpayer. Other documents were received from CPA, CPA, in response to Information Document Requests issued by the examining agent to the CPA during the current 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 _____ serves as Chief Executive Officer (CEO), President, Treasurer, and Assistant Secretary of _____. _____ serves as Vice President, Secretary, and Assistant Treasurer of the taxpayer.

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is also a significant owner of _____, and owns and/or is associated with various other business interests called "Affiliated Business Interests."

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, 20XX. It appears that the election statement was filed with the IRS _____, _____ office on the same day.

On October 14, 20XX, 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 20XX was the initial full 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, 20XX, with the Ogden Service Center. _____, President, signed the application on September 29, 20XX. 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 \$0 annually.

Around November 20XX, the Form 1024 application was referred to Rulings and Agreements in Washington, D.C., for consideration and ruling. The application was assigned to a Tax Law Specialist for review. No action was taken on the application until January 20XX. On January 7, 20XX, the Tax Law Specialist mailed a letter to the taxpayer's domestic address _____. A copy of the letter was mailed to the taxpayer's attorney, Indv-3. The letter requested additional information about the taxpayer's operations. The taxpayer's response to the letter was due by February 7, 20XX. _____ submitted the response to the request for additional information on February 19, 20XX.

The Form 1024 application administrative file does not reflect any more action taken on the organization's application by the Tax Law Specialist between late February 20XX, and mid-

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September 20XX. The taxpayer's President, _____, submitted a letter dated September 16, 20XX, requesting that the Form 1024 application be withdrawn from further consideration and ruling.

The Tax Law Specialist closed the Form 1024 application file without making a final determination whether the taxpayer did or did not qualify for IRC 501(c)(15) tax-exempt status.

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 March 31, 20XX, the TEGE examining agent requested the effective date of the IRC 953(d) election from the IRS _____ office. On April 1, 20XX, the IRS _____ office informed the examining agent that the Service does not have record that the IRC 953(d) election was ever approved.

The taxpayer's initial tax year consisted of the period, December 28, 20XX (the date of incorporation), through December 31, 20XX. The taxpayer did not file a return for its initial short tax year. The initial return filed by taxpayer was a Form 990 return for 20XX. Taxpayer also filed Form 990 returns for the 20XX, 20XX and 20XX tax years.

The Financial Services Commission, _____, issued a Class 'B: General Insurance License to the taxpayer effective December 28, 20XX. The taxpayer did not conduct any business during the period of December 28, 20XX, through December 31, 20XX. During the years under audit, the taxpayer operated primarily to provide property and casualty "insurance" coverage to _____, which is partially owned by _____ an officer and beneficial owner of _____.

In 20XX, the taxpayer wrote thirteen (13) direct-written contracts to _____ as follows: (1) Special Risk –Collection Rate, (2) Excess Directors & Officers Liability, (3) Excess Employment Practices Liability, (4) Special Risk – Expenses Reimbursement, (5) Special Risk – Loss of Major B2B Relationships; (6) Special Risk – Loss of Services, (7) Special Risk – Payee Audit Liability; (8) Special Risk – Representations and Warranties; (9) Special Risk – Breach of Medical Standards, (10) Excess Pollution Liability, (11) Special Risk – Regulatory Changes, (12) Special Risk – Punitive Wrap Liability, and (13) Special Risk – Tax Liability, Under the terms of each policy, _____ was listed as the Lead Insurer (0%). The taxpayer was listed as one of three Joint Insurers. Each Joint Insurer, _____; and _____, assumed 0% of the risk. _____ as Stop Loss Insurer, assumed the remaining 0% of the risk.

Each policy listed _____ (" "); _____ (" "); and the _____ (" "); located at Address, _____, as the Named Insureds.

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Supplemental information submitted by taxpayer with the Form 1024 application revealed that each of the Named Insureds is owned as follows:

0%
0%
0%

and are not related to or .

20XX Tax Year

1. Special Risk-Collection Rate Insurance Policy

(Policy Number:)

With the office practice currently billing several million dollars annually, a drop in its collection rate of only percentage points, where attributable to factors largely outside of control, such as levels of reimbursements by health insurers, pricing of services by third party payers including Medicare, etc) would result in a six-figure decrease in revenue.

2. Excess Directors & Officers Liability Insurance Policy

(Policy Number:)

Actions against the directors and officers may follow from patients, referring physicians, leased facilities, hospitals, managed care providers, or other third parties if billing procedures are alleged to be inappropriate.

3. Excess Employment Practices Liability Insurance Policy

(Policy Number:)

is at risk for employment practices liability for discrimination, harassment, wrongful termination, or similar wrongful act. Further, in some jurisdictions, these civil rights allegations can come from third parties such as patients.

4. Special Risk – Expense Reimbursement Insurance Policy

(Policy Number:)

may confront unanticipated allegation, suspension of professional licenses, or other adverse events, significant amounts of monies could be required for public relations crisis management to avert and offset negative publicity which could ultimately lead to a loss of business.

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5. Special Risk – Loss of Major Business to Business Relationship

(Policy Number:)

is a participant in virtually all of the major managed care insurance plans in the geographical area. of State, Medicare, and the Workers Compensation Commission of State represents business relationships where a significant exposure may exist.

6. Special Risk – Loss of Services Insurance Policy

(Policy Number:)

As a professional practice, the practice is highly dependent on the services of and . The business is at risk of significant income loss upon the incapacitation or loss of services from one or more of the insureds who are large or significant billers.

7. Special Risk-Payee Audit Liability Insurance Policy

(Policy Number:)

is at risk for potential unexpected costs or liability resulting from an audit, by the State Workers Compensation Commission, of its billed medical services provided for patient treatment of a worker's compensation related injury

8. Excess Pollution Liability Insurance Policy

(Policy Number:)

has a significant waste exposure which is excluded from its commercial general liability insurance coverage. It deals with "sharps" (used needles, etc.), bodily fluids, and chemical wastes on a daily basis. Handling procedures are in place; however, historical claims, occurring industry-wide, illustrate that improper handling is possible and represents a significant exposure. Further, contracts out its waste disposal and cannot guarantee the proper disposal of its waste once it leaves facilities. If these wastes are mishandled, a pollution incident could occur resulting in significant damage, injuries, cleanup costs, and fines.

9. Special Risk-Punitive Wrap Liability Insurance Policy

(Policy Number:)

The Company is at risk if a jurisdiction rules that its conventional liability coverage cannot provide coverage for punitive or exemplary damages. The damage awards are often significant multiples of the actual damages sought by a plaintiff.

10. Special Risk-Regulatory Changes Insurance Policy

(Policy Number:)

is at risk of external factors such as regulatory changes in the field specifically or in its industry as a whole, or even regulatory changes within the facilities at which operates. could incur significant costs to come into compliance with rules

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and regulations regarding _____ or _____. There is also the possibility that compliance may not be cost effective, thereby eliminating a revenue stream from the office practice and also resulting in a potential loss of patients.

11. Special Risk-Representation and Warranties Insurance Policy

(Policy Number: _____)

Under the terms of the May 20XX Reacquisition of assets of _____, assigned to rights to _____, to received certain amounts from other third parties under the Closing Documents or other agreements associated with the sale. _____ is at risk for any amounts that are subsequently deemed uncollectible.

12. Special Risk-Breach of Medical Standards Insurance Policy

(Policy Number: _____)

_____ is entrusted with and manages a large volume of sensitive personal information on patients. The volume of "incidents" and related lawsuits from the mishandling/security breach of sensitive personal information is on the rise – especially given the increasing reliance on electronic data processing and the growing threat of identity theft from underground and organized information thieves. These risks represent a potential and substantial exposure to _____.

13. Special Risk - Tax Liability Insurance Policy

(Policy Number: _____)

_____ is also at risk if it were to suffer an adverse decision from an unexpected tax audit with regard to its organizational structure, cash basis accounting, captive planning, billing methodology, or any other federal tax related issue.

Each of the above contracts appeared to have written and sold by another captive company called _____. In each contract, _____ is reflected as the Lead Insurer. In addition, the policy number reflected on each contract has the designation " _____" and then lists the type of contraction and the contract number. _____, as Lead Insurer, assumed 0% of the stated Limits of Insurance. _____ is reflected as one of three Joint Insurers, each of which assumed 0% of the stated Limited of Insurance. Together, the Lead and Joint Insurers assumed 0% of the stated Limits of Insurance. The remaining 0% of the stated Limited of Insurance was assumed by _____, as the Stop Loss Insurer. During 20XX, _____ did not write, sale or issue any direct written contracts to any related or unrelated parties for which it was the Lead Insurer.

Each direct written contract listed the Named Insured as _____; _____; and the _____, located at _____. The policy period for each contract was from January 1, 20XX to January 1, 20XX.

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The contracts also listed the aggregate limit of insurance and the premium paid by the total Combined Premium paid by the Named Insured as follows:

Contract	Aggregate Limit	Combined Premium
Special Risk-Collection Rate	\$ 0	\$ 0
Excess D&O Liability	0	0
Excess Employment Practices	0	0
Special Risk-Expense Reimb.	0	0
Special Risk-Loss of Major B2B	0	0
Special Risk-Loss of Services	0	0
Special Risk-Payee Audit	0	0
Excess Pollution Liability	0	0
Special Risk-Punitive Wrap	0	0
Special Risk-Regulatory Changes	0	0
Special Risk-Rep. and Warranties	0	0
Special Risk-Breach of Medical	0	0
Special Risk-Tax Liability	0	0
Totals	\$ 0	\$ 0

The taxpayer relied on the services of _____ and _____ to establish the premium rating methodology for the direct written contracts and the Quota Share Reinsurance Agreement.

Joint Underwriting Stop Loss Endorsement

With respect of each of the 13 above referenced property and casualty contracts, the taxpayer and _____ (“_____”) entered into an agreement titled, “Joint Underwriting Stop Loss Endorsement.” The taxpayer and _____ appear to be separate independent companies. However, it is not known whether the companies are owned and controlled by related parties. Under the terms of the agreement, the taxpayer is listed as the Lead Insurer, and is responsible for payment of claims incurred by the Named Insureds under the direct written contracts, up to certain specified thresholds. If the specified thresholds are met, then _____ as the Stop Loss Insurer, becomes liable for payment of claims up to certain secondary specified limits. If the specified limits for _____ payment of claims are exceeded, then the taxpayer again becomes liable. For 20XX, the Named Insureds paid a total Combined Premium of \$0 for the 13 direct written contracts. Of the total Combined Premium paid by the Named Insureds \$0 (or 0%) was paid to the taxpayer. Page 5, paragraph 4 of the agreement reads as follows:

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The premium rate for this Joint Underwriting Stop Loss Endorsement is 0% of the combined gross direct written premiums for the specified policies due directly from the Insured(s). This endorsement premium of \$0, out of the total premiums of \$0, is payable directly from the Insured(s) to the Stop Loss Insurer.

For the 13 direct written contracts and the Joint Underwriting Stop Loss Endorsement agreement, the Named Insureds was required to pay of total premiums of \$0. Of the total premium, \$0 (or 0%) was paid to _____, as Stop Loss Insurer, and the balance of \$0 (or 0%) was paid directly to the taxpayer, as Lead Insurer.

Quota Share Reinsurance Agreement

The taxpayer also entered into two types of reinsurance arrangements. The first arrangement is referred to as a "reinsurance risk pooling program." _____ executed a Quota Share Reinsurance Policy (# _____) with _____. The agreement indicates that _____ is located at _____, _____ is identified as the "Reinsurer" and _____ is the "Reinsured." The policy runs from January 1, 20XX, to January 1, 20XX.

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 0± insurance policies with more than 0± insureds. _____ blended together its direct written insurance and then reinsured the entire book on a quota share basis with each of the pool participants. The contract reflected a total of 44 reinsurers participating in the Quota Share Reinsurance Program in 20XX. As Reinsurer # _____, the taxpayer received a Quota Share Premium from _____ in exchange for the assumption of 0% of the risk pool comprised of the stop loss coverages issued during the policy period by _____ to all stop loss endorsement policyholders. In 20XX, _____ paid a total combined reinsurance premium of \$0 to the 44 reinsurers. Of this amount, _____ paid a quota share reinsurance premium of \$0 to the taxpayer based on its 0% of the risk pool assumed. According to the general ledger, the taxpayer received reinsurance premiums of \$0 from _____ in 20XX.

Credit Coinsurance Reinsurance Agreement

Under the terms of the second arrangement, which is referred to as the Credit Coinsurance Reinsurance Program, the taxpayer assumed reinsurance contracts from _____. The taxpayer reinsured a 0% quota share of the risks from vehicle service contracts reinsured by _____.

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The vehicle service contracts were initially written by _____ in 20XX, assumed by _____, then by _____ from _____; and finally assumed by _____ from _____. The taxpayer received a pro rata share of the earned premiums received by _____. The taxpayer was paid a reinsurance premium of \$0 from _____ in 20XX.

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

Direct Written Premiums	\$	0	0%
Quota Share Reinsurance Assumed		0	0
Other Reinsurance Assumed		0	0
Total	\$	0	0.00%

For the tax year ended December 31, 20XX, the taxpayer reported total revenue of \$0. Revenue was derived primarily from premiums received from the direct written, reinsurance risk pooling program, and the credit coinsurance reinsurance programs. The taxpayer reported revenue from the following sources:

<u>Per Return</u>	<u>20XX</u>
Program Revenue Service	
Direct Written Premiums	\$ 0
Quota Share Reinsurance Premiums	0
Credit Coinsurance Reinsurance Premiums	0
Total Premiums	0
Investment Income	0
Proceeds from sale of assets ¹	(0)
Other income	-0-
Gross Receipts	\$ 0

However, based on the audit, the gross receipts were adjusted as follows to comply with the guidelines for the IRC 501(c)(15) gross receipt tests described in Notice 20XX-42:

<u>Per Audit</u>	<u>20XX</u>
Program Revenue Service	
Direct Written Premiums	\$ 0
Quota Share Reinsurance Premiums	0
Credit Coinsurance Reinsurance Premiums	0
Total Premiums	0

¹ Proceeds of \$0 less cost basis of \$0, the _____ incurred a net loss of \$0. Only the net loss was reported on the return.

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Investment Income	0
Gains from sale of assets	0
Other income	<u>0</u>
Gross Receipts, per audit	\$ 0

The primary difference between gross receipts reported on the return and the gross receipts as adjusted during the audit is, only gains from the sale of assets were included in adjusted gross receipts based on the guidelines described in Notice 2006-42.

In 20XX, the taxpayer deposited the direct written premiums received from the Named Insureds into its investment account.

Of the total premiums received by the taxpayer in 20XX, 0% of the premiums were generated from the thirteen direct written policies with the Named Insureds, ; ; and the ; 0% of the premiums are from the Quota Share Reinsurance Risk Pooling Program; and 0% of the premiums from the Credit Coinsurance Reinsurance Program.

As of December 31, 20XX, the taxpayer's assets totaled \$0, and consisted primarily of securities and cash in the account.

20XX Tax Year

The taxpayer filed Form 990, *Return of Organization Exempt From Income Tax*, for the tax year ended December 31, 20XX, claiming to be tax-exempt under IRC 501(c)(15). 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 20XX tax year: (1) direct written contracts with affiliated business interests; (2) quota share risk pool reinsurance; (3) credit coinsurance reinsurance. The taxpayer wrote fourteen (14) direct contracts to insure certain property and casualty of Affiliated Business Interests. The taxpayer wrote many of the same direct contracts as was written in 20XX, with a couple of exceptions. The taxpayer dropped the Special Risk-Loss of Services and the Special Risk-Representation and Warranties contracts in 20XX. However, the taxpayer added the Special Risk-Legal Expense Reimbursement and the Excess Cyber Risk contracts in 20XX. The contracts appear to have been written by , as Lead Insurer. The fourteen contracts were written for the policy period of January 1, 20XX, to January 1, 20XX. None of the fourteen direct contracts identified the names of the Insurers. The contracts either never included this information, or the contracts were sanitized of this information before the documents were submitted to the examining agent for review. However, the Joint Underwriting Endorsement did reveal that the taxpayer was one of four Insurers that assumed risk under the direct written contracts. The taxpayer assumed 0% of the stated Limits of Insurance in exchange for 0% of the Combined Premium paid the Named

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Insureds. Based on the information revealed during the review of the 20XX contracts, the other Insurers involved in the direct written contracts were _____ and _____ appears to be the Lead Insurer, and _____ and _____ appear to be Joint Insurers. The four captive companies assumed 0% of the stated Limits of Insurance in exchange for 0% of the Combined Premium paid the Named Insureds. The remaining 0% of the Combined Premium was paid to _____, as the Stop Loss Insurer.

In 20XX, the direct written contracts listed the same three Named Insureds: _____; _____; and _____. However, General Endorsement Changes were made removing the _____ as one of the three Named Insureds, and transferring its risk to another captive company. Effective October 1, 20XX, through January 1, 20XX, the insurance coverages for the _____ was transferred from _____ to another unknown captive company. In the response to IDR #1 for the 20XX and 20XX tax years, the taxpayer's _____, CPA, provided two sets of direct written contracts in effective during 20XX. The CPA provided the fourteen contracts written by _____, in which the taxpayer is a Joint Insurer. The CPA also provided a copy of the 14 fourteens written by an unknown Lead Insurer. The designation of the Lead Insurer is _____. In his September 27, 20XX cover letter that accompanied the response to IDR #1 for 20XX and 20XX, the CPA stated the confidential information of third was removed.

Taxpayer participated as a Joint Insurer in the following direct contracts written by _____ with the _____ and _____:

Contract Name	Policy Number	Aggregate Limit	Premium
1. Special Risk – Collection Rate		\$ 0	\$ 0
2. Excess Directors & Officers Liability		0	0
3. Excess Employment Practices Liability		0	0
4. Special Risk – Expense Reimbursement		0	0
5. Expense Reimbursement – Legal Expenses		0	0
6. Excess Pollution Liability		0	0
7. Special Risk – Punitive Wrap		0	0
8. Special Risk – Regulatory Changes		0	0
9. Special Risk – Tax Liability		0	0
10. Expense Reimbursement – Breach of Medical		0	0
11. Payer Audit Liability		0	0
12. Special Risk – Loss of Major B2B		0	0
13. Special Risk – Commercial Medical Malprac.		0	0
14. Excess Cyber Risk		0	0
Totals		\$ 0	\$ 0

The 20XX direct written premiums charged by the Lead Insurer were lower than the 20XX premiums because _____ coverages were transferred to another captive. Taxpayer did not write, sale or issue direct written contracts to the general public or unrelated third parties.

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Effective October 1, 20XX, the coverages for [redacted] were transferred to another unknown captive company. [redacted] insured the same property and casualty coverages with [redacted] as with [redacted], with the exception that the Excess Cyber Risk contract was replaced by a Special Risk- Loss of Service contract. [redacted] is listed as the only Named Insured under the fourteen direct contracts written by [redacted].

Under the terms of the Joint Underwriting Endorsement with [redacted], the taxpayer is listed as one of five Insurers. The taxpayer appears to be a Joint Insurer that agreed to assume 0% of the stated Limits of Insurance in exchange for 0% of the Combined Written Premium by [redacted]. The other four Insurers assumed the remaining 0% of the stated Limits of Insurance in exchange for 0% of the Combined Premium paid by [redacted]. Together, the five Insurers assumed 0% of the stated Limited of Insurance in exchange for 0% of the Combined Premium paid by [redacted]. The remaining 0% of the Combine Premium was paid to [redacted] as a Stop Loss Insurer under the Joint Underwriting Endorsement. Page 1 of the Joint Underwriting Endorsement includes the following language:

(" [redacted] "), as the Stop Loss Insurer, is not Subject to Quota Share Participation, and is instead subject to the Joint Underwriting Stop Loss Endorsement to the Policy.

In 20XX, the taxpayer participated as a Joint Insurer under the following direct contracts written by [redacted]:

<u>Contract Name</u>	<u>Policy Number</u>	<u>Aggregate Limit</u>	<u>Premium</u>
1. Special Risk – Collection Rate		0	0
2. Excess Directors and Officers		0	0
3. Excess Employment Practices		0	0
4. Special Risk – Expense Reimbursement		0	0
5. Legal Expense Reimbursement		0	0
6. Excess Pollution Liability		0	0
7. Special Risk – Punitive Wrap		0	0
8. Special Risk – Regulatory Changes		0	0
9. Special Risk – Tax Liability		0	0
10. Breach of Medical Standards		0	0
11. Payer Audit Liability		0	0
12. Special Risk – Commercial Medical Mal.		0	0
13. Special Risk – Loss of Major B2B		0	0
14. Special Risk – Loss of Service		0	0
Totals		\$ 0	\$ 0

According to the business plan, the taxpayer purchased the direct written contracts because of the following exposures:

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1. Special Risk-Collection Rate Insurance Policy

With the office practice currently billing several million dollars annually, a drop in its collection rate of only percentage points, where attributable to factors largely outside of control, such as levels of reimbursements by health insurers, pricing of services by third party payers including Medicare, etc) would result in a six-figure decrease in revenue.

2. Excess Directors & Officers Liability Insurance Policy

Actions against the directors and officers may follow from patients, referring physicians, leased facilities, hospitals, managed care providers, or other third parties billing procedures are alleged to be inappropriate.

3. Excess Employment Practices Liability Insurance Policy

is at risk for employment practices liability for discrimination, harassment, wrongful termination, or similar wrongful act. Further, in some jurisdictions, these civil rights allegations can come from third parties such as patients.

4. Special Risk – Expense Reimbursement Insurance Policy

may confront unanticipated allegation, suspension of professional licenses, or other adverse events, significant amounts of monies could be required for public relations crisis management to avert and offset negative publicity which could ultimately lead to a loss of business.

5. Special Risk – Legal Expense Reimbursement

The contract covers all litigation expenses incurred by the Company resulting from actual of alleged civil liability.

6. Excess Pollution Liability Insurance Policy

has a significant waste exposure which is excluded from its commercial general liability insurance coverage. It deals with “sharps” (used needles, etc.), bodily fluids, and chemical wastes on a daily basis. Handling procedures are in place; however, historical claims, occurring industry-wide, illustrate that improper handling is possible and represents a significant exposure. Further, contracts out its waste disposal and cannot guarantee the proper disposal of its waste once it leaves facilities. If these wastes are mishandled, a pollution incident could occur resulting in significant damage, injuries, cleanup costs, and fines.

7. Special Risk-Punitive Wrap Liability Insurance Policy

The Company is at risk if a jurisdiction rules that its conventional liability coverage cannot provide coverage for punitive or exemplary damages. The damage awards are often significant multiples of the actual damages sought by a plaintiff.

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8. Special Risk-Regulatory Changes Insurance Policy

is at risk of external factors such as regulatory changes in the field specifically or in its industry as a whole, or even regulatory changes within the facilities at which operates. could incur significant costs to come into compliance with rules and regulations regarding or . There is also the possibility that compliance may not be cost effective, thereby eliminating a revenue stream from the office practice and also resulting in a potential loss of patients.

9. Special Risk - Tax Liability Insurance Policy

is also at risk if it were to suffer an adverse decision from an unexpected tax audit with regard to its organizational structure, cash basis accounting, captive planning, billing methodology, or any other federal tax related issue.

10. Special Risk-Breach of Medical Standards Insurance Policy

is entrusted with and manages a large volume of sensitive personal information on patients. The volume of "incidents" and related lawsuits from the mishandling/security breach of sensitive personal information is on the rise – especially given the increasing reliance on electronic data processing and the growing threat of identity theft from underground and organized information thieves. These risks represent a potential and substantial exposure to

11. Special Risk - Payee Audit Liability Insurance Policy

is at risks for potential unexpected costs or liability resulting from an audit, by the State Workers Compensation Commission, of its billed medical services provided for patient treatment of a worker's compensation related injury.

12. Special Risk – Loss of Major Business to Business Relationship

is a participant in virtually all of the major managed care insurance plans in the geographical area. of State, Medicare, and the Workers Compensation Commission of State represents business relationships where a significant exposure may exist.

13. Special Risk – Loss of Services Insurance Policy

As a professional practice, the practice is highly dependent on the services of and . The business is at risk of significant income loss upon the incapacitation or loss of services from one or more of the insureds who are large or significant billers.

14a. Special Risk – Commercial Medical Malpractice

The contract provides commercial malpractice coverage for the insured during the 20XX calendar year. The contract reimburses the Named Insured for any loss sustained for which a

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Claim against the underlying insurance policy specified above is denied solely and exclusively to the exclusion, endorsement, or limitation specified above.

14b. Excess Cyber Risk

The contract protects the Named Insured from losses resulting from cyber-attacks such as computer viruses, unauthorized access through cyber presence; and degradation or loss to its system due to cyber presence.

JOINT UNDERWRITING ENDORSEMENT

In addition to the direct property and casualty insurance contracts, the taxpayer also executed separate Joint Underwriting Stop Loss Endorsements, with _____, for the _____ and _____ contracts, whereby both parties agreed to underwrite the insurance coverages described in the 14 policies with the Affiliated Business Interests.

Under the _____ Joint Underwriting Endorsement, the taxpayer is identified as one of four Insurers. The other three Lead Insurers were sanitized from the contract. However, the examining agent believes the parties are _____, _____, and _____. The taxpayer assumed 0% of the stated Limits of Insurance in exchange for 0% of the Combined Premium paid the Named Insureds.

Under the _____, the taxpayer is identified as one of five Insurers. The names of the other four Insurers were sanitized from the agreement by the taxpayer's CPA. However, the agreement reveals that taxpayer assumed 0% of the stated Limits of Insurance in exchange for 0% of the Combined Premium paid by _____, as the sole Named Insured. The terms of the endorsements included the following language:

The Limits of Insurance shall be borne proportionately by all Quota Share participants listed herein to a combined maximum of 0% of the Limits of Liability stated in the Declarations.

_____, as the Stop Loss Insurer, is not subject to Quota Share Participation, and is instead subject to the Joint Underwriting Stop Loss Endorsement to the Policy.

Under the _____ and _____, the Insurers assumed 0% of the stated Limits of Insurance in exchange for 0% of the Combined Premium by the Named Insureds. The remaining 0% of the Combined Premium was paid by the Named Insureds directly to _____

Therefore, in 20XX, the Combined Premium paid by the Named Insureds under the fourteen _____ and _____ contracts was allocated to the taxpayer as follows:

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14	Direct Written Contracts				
	Total combined premium	\$	0 @	0%	\$0
14	Direct Written Contracts				
	Total combined premium	\$	0 @	0%	<u>0</u>
Total Direct Written Premiums Rec'd by Taxpayer in 20XX					\$0

QUOTA SHARE REINSURANCE POLICY

Taxpayer continued to participate in the reinsurance risk pooling program by executing a Quota Share Reinsurance Policy (#) with . The agreement indicates that is located at , , . Taxpayer is identified as the "Reinsurer" and is the "Reinsured."

According to the terms , as reinsurer, received a Quota Share Premium from in exchange for the assumption of 0% of the risk pool comprised of the stop loss coverages issued during the policy period by to all stop loss endorsement policyholders. The policy period runs from January 1, 20XX, through January 1, 20XX.

The contract reflects a total of 58 reinsurers participating in the Quota Share Reinsurance Program. paid total reinsurance premiums of \$0 to the 58 reinsurers. is not identified by number. However, there are three reinsurers listed on page 2 of Schedule 1 of the contract that assumed 0% of the quota share risk pool. could either be Reinsurer # , Reinsurer # , or Reinsurer # . It is not pertinent to determine which of the three reinsurers represents . For purposes of the case write up, the examining agent identified as Reinsurer # .

As Reinsurer # , received a quota share reinsurance policy premium of \$0, which was equal to 0% of the total premium of \$0. Of the \$0 quota share premium received from , \$0 is the portion of the premium retained by (as a quota share retained premium) until the final accounting and settlement of the Risk Pool is completed. The final accounting and settlement generally occurs 180 days following the expiration date shown in the Policy declaration. The quota share retained premium is calculated at 0% of the quota share reinsurance policy premium of \$0.

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CREDIT INSURANCE COINSURANCE CONTRACT

Taxpayer continued to participate in the Credit Coinsurance Contract with _____, a _____, in which the taxpayer agreed to reinsure a prorata share (0%) of "all net retained policies in force on the effective date assumed by _____ from _____ a _____ corporation under a treaty dated June 1, 20XX, with _____, an _____ corporation that was merged into _____, on January 1, 20XX.

The risks reinsured are the 20XX insurance exposures on all policies of vehicle service contracts direct written by _____ in force on January 1, 20XX, and subsequently issued, and assumed by _____, from _____, under its treaty dated January 1, 20XX.

The reinsurance premiums to be paid by _____ to the Taxpayer shall be taxpayer's pro rata share (0%) of the earned premiums during the accounting period under each reinsured policy. Earned premiums are the gross premiums charged the insureds plus the unearned premiums at the beginning of the Accounting Period less the unearned premiums at the end of the Accounting Period. Taxpayer received \$0 in reinsurance premiums under this contract in 20XX.

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

Direct Written Premiums	\$	0	0%
Quota Share Reinsurance Assumed		0	0
Other Reinsurance Assumed		0	0
Total	\$	0	0.00%

For the tax year ended December 31, 20XX, the taxpayer reported gross receipts of \$0 and total revenue of \$0. Gross receipts were derived primarily from premiums received from the direct written, reinsurance risk pooling program, and the credit coinsurance reinsurance program. The taxpayer received gross receipts as follows:

	<u>20XX</u>	
Program Revenue Service		
Direct Written Premiums	\$	0
Quota Share Reinsurance Premiums		0
Credit Coinsurance Reinsurance Premiums		0
Total Premiums		0 0%
Investment Income		0
Proceeds from sale of assets ²		0
Other income		-0- 0.00
Gross Receipts		0 0.00%

²After offsetting cost basis of \$0, the _____ incurred a net gain of \$0. Only the net gain was reported on the return.

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The 20XX direct written premiums were deposited to the taxpayer's Investment Account. The investment account statements revealed that the taxpayer received the direct written premiums from the following payers:

	\$	0	0%
		0	0
		<u>0</u>	<u>0</u>
Total	\$	0	0.00%

A list of the deposits is shown in Exhibit A that is attached to the end of this report.

Of the total premiums received by the taxpayer in 20XX, 0% of the premiums were generated for the fourteen direct written policies with the Affiliated Business Interests, 0% of the premiums are from the Quota Share Reinsurance Risk Pooling Program; and 0% of the premiums from the Credit Coinsurance Reinsurance Program.

20XX Tax Year

The taxpayer filed Form 990, *Return of Organization Exempt From Income Tax*, for the tax year ended December 31, 20XX, claiming to be tax-exempt under IRC 501(c)(15). 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 20XX and 20XX tax years: (1) direct written contracts with affiliated business interests; (2) quota share risk pool reinsurance; (3) credit coinsurance reinsurance.

Taxpayer's primary business continued to be that of providing property and casualty coverages for the Named Insureds, , and . Taxpayer continued to operate as a Joint Insurer for property and casualty coverages written for the Named Insureds by and . continued to provide property and casualty coverages to and , and continued to provide coverages to .

During 20XX, the taxpayer continued to operate as a Joint Insurer under the same 14 property and casualty contracts written by , and the , as in the 20XX tax year. As in 20XX, taxpayer was one of four Insurers providing coverage to the Named Insureds. Although the contracts were sanitized by taxpayer's CPA, it appears that continued to serve as the Lead Insurer, while , and were Joint Insurers. The Lead Insurer assumed 0% of the stated Limits of Insurance in exchange for 0% of the Combined Premium paid by the Named Insureds. While each of the Joint Insurers assumed 0% of the stated Limits of Insurance in exchange for 0% of the Combined Premium.

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Together, the Insurers assumed 0% of the stated Limits of Insurance in exchange for 0% of the Combined Premium paid by the Named Insureds. The remaining 0% of the Combined Premium was paid by the Named Insureds to _____, as Stop Loss Insurer under the Joint Underwriting Endorsement.

The 14 contracts written by _____, in 20XX, continued to list the Named Insureds as: _____; _____; and _____, even though _____ coverages were transferred to _____ effective October 1, 20XX. _____ do not remove _____ as a Named Insureds from its 14 property and casualty contracts even though it was suppose to provide coverage only to _____ and _____. However, the 14 contracts written by _____ did reflect _____ as the sole Named Insured. The policy period for each contract is January 1, 20XX, through January 1, 20XX.

During 20XX, the taxpayer did not insure direct contracts with unrelated and unaffiliated parties, or the general public. Nor did the taxpayer write any direct contracts, during the years under audit, with related or unrelated parties where it served as Lead Insurer.

Taxpayer served as a Joint Insurer under the following contracts written by _____ in 20XX.

<u>Contract Name</u>	<u>Policy Number</u>	<u>Aggregate Limit</u>	<u>Premium</u>
1. Special Risk – Collection Rate		\$ 0	\$ 0
2. Excess Directors & Officers Liability		0	0
3. Excess Employment Practices Liability		0	0
4. Special Risk – Expense Reimbursement		0	0
5. Expense Reimbursement – Legal Expenses		0	0
6. Excess Pollution Liability		0	0
7. Special Risk – Punitive Wrap		0	0
8. Special Risk – Regulatory Changes		0	0
9. Special Risk – Tax Liability		0	0
10. Expense Reimbursement – Breach of Medical		0	0
11. Payer Audit Liability		0	0
12. Special Risk – Loss of Major B2B		0	0
13. Special Risk – Commercial Medical Mal.		0	0
14. Excess Cyber Risk		0	0
Totals		\$ 0	\$ 0

With respect to the _____ contracts, the taxpayer was one of five Insurers that provided property and casualty coverage to _____, as the sole Named Insured. Under the terms of the contracts, the taxpayer is listed as one of five Insurers. The names of the Lead Insurer and other Joint Insurers were sanitized by the CPA. The contracts continue to list _____ as the sole Named Insured.

Taxpayer agreed to assume 0% of the stated Limits of Insurance in exchange for 0% of the Combined Premium paid by the Named Insured. Together, the five insurers agreed to insure

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100% of the stated Limits of Insurance in exchange for 0% of the Combined Premium paid by , as the sole Named Insured. The remaining 0% of the Combined Premium was paid by to , as the Stop Loss Insurer under the Joint Underwriting Endorsement.

Taxpayer served as a Joint Insurer under the following contracts written by in 20XX.

<u>Contract Name</u>	<u>Policy Number</u>	<u>Aggregate Limit</u>	<u>Premium</u>
1. Special Risk – Collection Rate		\$ 0	\$ 0
2. Excess Directors & Officers Liability		0	0
3. Excess Employment Practices Liability		0	0
4. Special Risk – Expenses Reimbursement		0	0
5. Expense Reimbursement – Legal Expenses		0	0
6. Excess Pollution Liability		0	0
7. Special Risk – Punitive Wrap		0	0
8. Special Risk – Regulatory Changes		0	0
9. Special Risk – Tax Liability		0	0
10. Expense Reimbursement – Breach of Med.		0	0
11. Payer Audit Liability		0	0
12. Special Risk – Loss of Major B2B		0	0
13. Special Risk – Commercial Medical Mal.		0	0
14. Special Risk – Loss of Service		0	\$ 0
Totals		\$ 0	\$ 0

According to the business plan, the taxpayer purchased the direct written contracts because of the following exposures:

1. Special Risk-Collection Rate Insurance Policy

With the office practice currently billing dollars annually, a drop in its collection rate of only percentage points, where attributable to factors largely outside of control, such as levels of reimbursements by health insurers, pricing of services by third party payers including Medicare, etc) would result in a six-figure decrease in revenue.

2. Excess Directors & Officers Liability Insurance Policy

Actions against the directors and officers may follow from patients, referring physicians, leased facilities, hospitals, managed care providers, or other third parties if billing procedures are alleged to be inappropriate.

3. Excess Employment Practices Liability Insurance Policy

is at risk for employment practices liability for discrimination, harassment, wrongful termination, or similar wrongful act. Further, in some jurisdictions, these civil rights allegations can come from third parties such as patients.

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4. Special Risk – Expense Reimbursement Insurance Policy

may confront unanticipated allegation, suspension of professional licenses, or other adverse events, significant amounts of monies could be required for public relations crisis management to avert and offset negative publicity which could ultimately lead to a loss of business.

5. Special Risk – Legal Expense Reimbursement

The contract covers all litigation expenses incurred by the Company resulting from actual of alleged civil liability.

6. Excess Pollution Liability Insurance Policy

has a significant waste exposure which is excluded from its commercial general liability insurance coverage. It deals with “sharps” (used needles, etc.), bodily fluids, and chemical wastes on a daily basis. Handling procedures are in place; however, historical claims, occurring industry-wide, illustrate that improper handling is possible and represents a significant exposure. Further, contracts out its waste disposal and cannot guarantee the proper disposal of its waste once it leaves facilities. If these wastes are mishandled, a pollution incident could occur resulting in significant damage, injuries, cleanup costs, and fines.

7. Special Risk-Punitive Wrap Liability Insurance Policy

The Company is at risk if a jurisdiction rules that its conventional liability coverage cannot provide coverage for punitive or exemplary damages. The damage awards are often significant multiples of the actual damages sought by a plaintiff.

8. Special Risk-Regulatory Changes Insurance Policy

is at risk of external factors such as regulatory changes in the field specifically or in its industry as a whole, or even regulatory changes within the facilities at which operates. could incur significant costs to come into compliance with rules and regulations regarding or . There is also the possibility that compliance may not be cost effective, thereby eliminating a revenue stream from the office practice and also resulting in a potential loss of patients.

9. Special Risk - Tax Liability Insurance Policy

is also at risk if it were to suffer an adverse decision from an unexpected tax audit with regard to its organizational structure, cash basis accounting, captive planning, billing methodology, or any other federal tax related issue.

10. Special Risk-Breach of Medical Standards Insurance Policy

is entrusted with and manages a large volume of sensitive personal information on patients. The volume of “incidents” and related lawsuits from the mishandling/security breach

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of sensitive personal information is on the rise – especially given the increasing reliance on electronic data processing and the growing threat of identity theft from underground and organized information thieves. These risks represent a potential and substantial exposure to

11. Special Risk - Payee Audit Liability Insurance Policy

is at risks for potential unexpected costs or liability resulting from an audit, by the State Workers Compensation Commission, of its billed medical services provided for patient treatment of a worker’s compensation related injury.

12. Special Risk – Loss of Major Business to Business Relationship

is a participant in virtually all of the major managed care insurance plans in the geographical area. of State, Medicare, and the Workers Compensation Commission of State represents business relationships where a significant exposure may exist.

13. Special Risk – Loss of Services Insurance Policy

As a professional practice, the practice is highly dependent on the services of and . The business is at risk of significant income loss upon the incapacitation or loss of services from one or more of the insureds who are large or significant billers.

14a. Special Risk – Commercial Medical Malpractice

The contract provides commercial malpractice coverage for the insured during the 20XX calendar year. The contract reimburses the Named Insured for any loss sustained for which a Claim against the underlying insurance policy specified above is denied solely and exclusively to the exclusion, endorsement, or limitation specified above.

14b. Excess Cyber Risk

The contract protects the Named Insured from losses resulting from cyber-attacks such as computer viruses, unauthorized access through cyber presence; and degradation or loss to its system due to cyber presence.

JOINT UNDERWRITING ENDORSEMENT

In addition to the direct property and casualty insurance contracts, the taxpayer also executed separate Joint Underwriting Stop Loss Endorsements, with , for and contracts, whereby both parties agreed to underwrite the insurance coverages described in the 14 policies with the Affiliated Business Interests.

Under the Joint Underwriting Endorsement, the taxpayer is identified as one of four Insurers. The other three Lead Insurers were sanitized from the contract. However, the

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examining agent believes the parties are _____, _____, and _____. The taxpayer assumed 0% of the stated Limits of Insurance in exchange for 0% of the Combined Premium paid the Named Insureds.

Under the _____ Joint Underwriting Endorsement, the taxpayer is identified as one of five Insurers. The names of the other four Insurers were also sanitized from the agreement by the taxpayer's CPA. However, the agreement reveals that taxpayer assumed 0% of the stated Limits of Insurance in exchange for 0% of the Combined Premium paid by _____, as the sole Named Insured.

The terms of the endorsements included the following language:

The Limits of Insurance shall be borne proportionately by all Quota Share participants listed herein to a combined maximum of 0% of the Limits of Liability stated in the Declarations.

_____, as the Stop Loss Insurer, is not subject to Quota Share Participation, and is instead subject to the Joint Underwriting Stop Loss Endorsement to the Policy.

Under the _____ and _____ Joint Underwriting Endorsements, the Insurers assumed 0% of the stated Limits of Insurance in exchange for 0% of the Combined Premium by the Named Insureds. The remaining 0% of the Combined Premium was paid by the Named Insureds directly to _____.

Therefore, in 20XX, the Combined Premium paid by the Named Insureds under the fourteen _____ and _____ contracts was allocated to the taxpayer as follows:

14	Direct Written Contracts					
	Total combined premium	\$	0	@	0%	\$ 0
14	Direct Written Contracts					
	Total combined premium	\$	0	@	0%	<u> 0</u>
	Total Direct Written Premiums Rec'd by Taxpayer in 20XX					\$ 0

QUOTA SHARE REINSURANCE POLICY

Taxpayer continued to participate in the reinsurance risk pooling program by executing a Quota Share Reinsurance Policy (# _____) with _____. The agreement indicates that _____ is

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located at _____, _____, _____. Taxpayer is identified as the "Reinsurer" and _____ is the "Reinsured."

According to the terms _____, as reinsurer, received a Quota Share Premium from _____ in exchange for the assumption of 0% of the risk pool comprised of the stop loss coverages issued during the policy period by _____ to all stop loss endorsement policyholders. The policy period runs from January 1, 20XX, through January 1, 20XX.

The policy reflects a total of 53 reinsurers participating in the Quota Share Reinsurance Program. Taxpayer is identified as Reinsurer # _____ in Schedule 1A attached to the policy. In 20XX, _____ paid premiums of \$0 to the 53 reinsurers.

As Reinsurer # _____, Taxpayer received a quota share reinsurance policy premium of \$0, which was equal to 0% of the total premium of \$0 paid by _____ to the reinsurers.

CREDIT INSURANCE COINSURANCE CONTRACT

Taxpayer continued to participate in the Credit Coinsurance Contract with _____, a _____, in which the taxpayer agreed to reinsure a prorata share (0%) of "all net retained policies in force on the effective date assumed by _____ from _____ an _____ corporation under a treaty dated June 1, 20XX, with _____, a _____ corporation that was merged into _____, on January 1, 20XX.

The risks reinsured are the 20XX insurance exposures on all policies of vehicle service contracts direct written by _____ in force on January 1, 20XX, and subsequently issued, and assumed by _____, from _____, under its treaty dated January 1, 20XX.

The reinsurance premiums to be paid by _____ to the Taxpayer shall be taxpayer's pro rata share (0%) of the earned premiums during the accounting period under each reinsured policy. Earned premiums are the gross premiums charged the insureds plus the unearned premiums at the beginning of the Accounting Period less the unearned premiums at the end of the Accounting Period. Taxpayer received \$0 in reinsurance premiums under this contract in 20XX.

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

Direct Written Premiums	\$ 0	0%
Quota Share Reinsurance Assumed	0	0
Other Reinsurance Assumed	<u>0</u>	<u>0</u>
Total	\$ 0	0.00%

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For the tax year ended December 31, 20XX, the taxpayer reported gross receipts of \$0 and total revenue of \$0. Gross receipts were derived primarily from premiums received from the direct written, reinsurance risk pooling program, and the credit coinsurance reinsurance program. The taxpayer received gross receipts as follows:

	<u>20XX</u>	
Program Revenue Service		
Direct Written Premiums	\$ 0	
Quota Share Reinsurance Premiums	0	
Credit Coinsurance Reinsurance Premiums	<u>0</u>	
Total Premiums	0	0%
Investment Income	0	0
Proceeds from sale of assets ³	0	0
Other income	<u>0</u>	<u>0</u>
Gross Receipts	0	0.00%

The 20XX direct written premiums were deposited to the taxpayer's Investment Account. The investment account statements revealed that the taxpayer received the direct written premiums from the following payers:

	\$ 0	0%
	0	0
	<u>0</u>	<u>0</u>
Total	\$ 0	0.00%

A list of the deposits is shown in Exhibit B that is attached to the end of this report.

Of the total premiums received by the taxpayer in 20XX, 0% of the premiums were generated for the fourteen direct written policies with the Affiliated Business Interests, 0% of the premiums are from the Quota Share Reinsurance Risk Pooling Program; and 0% of the premiums from the Credit Coinsurance Reinsurance Program.

20XX Tax Year

Taxpayer filed Form 990 for the tax year ended December 31, 20XX. The insurance contracts and books and records for 20XX were not reviewed during the audit. Although, the taxpayer reported income and expenses similar to that reported on the returns examined. Thus, it is safe to assume that the taxpayer operated in the same manner as it did during the years actually examined. In addition, it is safe to assume that the taxpayer executed the same or similar direct written insurance and reinsurance contracts in 20XX.

³After offsetting cost basis of \$0, the incurred a net gain of \$0. Only the net gain was reported on the return.

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On the Form 990 for 20XX, taxpayer reported the following sources of income:

<u>20XX</u>		
Program Revenue Service		
Direct Written Premiums	\$ 0	
Quota Share Reinsurance Premiums	0	
Credit Coinsurance Reinsurance Premiums	0	
Total Premiums	0	0%
Investment Income	0	0
Gain of sale of assets	0	0
Other income	0	0
Total Revenue	\$ 0	0.00%

During 20XX, the taxpayer reported total premiums and assumed risk as follows:

Direct Written Premiums	\$ 0	0%
Quota Share Reinsurance Assumed	0	0
Other Reinsurance Assumed	0	0
Total	\$ 0	0.00%

During the tax years under audit, total assets ranged from a low of \$0 as of December 31, 20XX, to \$0, as of December 31, 20XX. The assets included loans to the affiliated businesses of \$0. The initial loan was made by taxpayer to the affiliated business in 20XX, in the amount of \$0. The outstanding loan balance increased to \$0 in 20XX. The loan was repaid by the affiliated business during the 20XX tax year. As of December 31, 20XX, the outstanding loan receivable balance was zero.

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:

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

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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 816(a) of the Code 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 the reinsuring of risks underwritten by insurance companies.

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 performance 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-

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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. —

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(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.

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(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 October 14, 20XX, seeking retroactive exemption under IRC 501(c)(15), back to December 28, 20XX, the date of incorporation. The application was ultimately withdrawn by _____, President, on September 16, 20XX. The examining agent believes that the application was withdrawn by the company on the advice on its counsel, _____, and Indv-3, who are affiliated with _____, in _____. The examining agent believes that its counsel advised the taxpayer 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

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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

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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. Panier, ed., 2001).

Insurance risk requires a fortuitous event or hazard and not a mere timing or investment risk. A fortuitous event⁴ (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.

⁴ 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."

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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 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.

20XX

1. Special Risk – Collection Rate Insurance Policy

Policy indemnifies for a portion of the differential between the Net Collection Percentage (NCP) during the covered period and the NCP during a baseline period. The NCP is calculated by dividing the actual collections amount during a specified period into the gross billings amount for that same period.

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

2. Excess Directors & Officers Liability Insurance Policy.

Covers wrongful acts of directors and officers.

Insurance.

3. Excess Employment Practices Liability Insurance Policy.

Covers 11 categories of wrongful acts including wrongful termination, refusal to hire or promote, sexual harassment, unlawful discrimination based on age, gender, etc., invasion of privacy, failure to create employment policies or procedures, retaliatory treatment, violation of civil rights, violation of Family and Medical Leave Act, breach of employment contract, failure to provide safe work environment, violations listed herein against a non-employee. There is excluded from coverage claims related to employee's entitlements under various listed non-specific laws, rules or regulations. Also excluded are claims under various listed laws such as the Occupational Safety and Health Act. These exclusions shall not apply to claim for any actual or alleged retaliatory, discriminatory, or other employment practices-related treatment.

Not insurance.

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Policy is not insurance in its commonly accepted sense. There is no insurance risk but only investment or business risk.

4. 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 \$0; 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 0%.

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. Coverage Form A is not insurance in the commonly accepted sense. There is no insurance risk but only investment or business risk. The description of Coverage B is vague as to what liability/contract underlies the need for defense expenses. Consider obtaining more information.

5. Special Risk – Loss of Major Business to Business

Covers any business interruption loss of up to months suffered as a result of losing the services of a Major Business-to-Business Relationship (any business relationship that contributes 0% or more to revenue). Business interruption losses include the impact of lost revenue and the extra expenses involved in finding a replacement Business-to-Business Relationship. The policy will not cover the voluntary loss of a Major Business-to-Business Relationship where the insured initiates the termination of the agreement; the loss of a Major Business-to-Business Relationship that insured did not attempt or intent to replace; or the loss of a Major Business-to-Business Relationship due to insured's substantial non-compliance with the terms and conditions of its contractual agreement with the customer.

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

6. Special Risk – Loss of Services Insurance Policy.

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Covers the involuntary loss of services for key employees. The covered cause of loss must be involuntary and includes sickness, disability, death, loss of license, resignation or retirement after 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. Claim costs can include costs incurred by existing employees, costs of temporary employees, training costs, and lost net revenue.

Not insurance. 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. Special Risk – Payee Audit

Covers amount of unexpected audit liability insured incurs as a result from audit by the State Workers Compensation Commission (SWCC) of insured's billed medical services provided for patient treatment of a workers compensation-related injury. Also covers defense expenses insured incurs in preparing for, or participating in any SWCC audit.

Not insurance. Insureds are located in State. It is very questionable whether an audit from the State Workers Compensation Commission is even a possibility; therefore, there would be no risk to insure. If insureds do provide medical care in State, then the policy is still probably not insurance in the commonly accepted sense because there is no insurance risk but only investment or business risk.

8. Excess Pollution Liability Insurance Policy.

Insuring Agreement 1 and 2 cover clean-up costs and diminution in value costs resulting from pre-existing or new on-site pollution conditions. Coverage is conditioned on an affirmative obligation to report on site pollution conditions to a governmental agency so as to be in compliance with environmental laws. Various laws covering solid waste disposal, super funds, clean air, clean water, and toxic substances are listed in a non-exclusive list provided the insured has or may have a legal obligation to incur clean up costs for pollution conditions or pollution release. Clean up costs cover the expenses of investigation or removal of, or rendering non-hazardous pollution conditions to the extent required by environmental laws. Diminution in value means the difference in the fair market value of the property when the remedial action plan is approved and the fair market value of the property had there been no on site pollution conditions.

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Insuring Agreements 3 to 12 provide for third party claims for on site or off site clean up and diminution in value costs for pre-existing or new on site or off site pollution conditions, as well as bodily and property damage, as well as non-owned locations.

Insuring Agreement 13 covers pollution release from transported cargo carried by covered autos. No covered auto is identified in the declarations.

Insuring Agreement 14 covers third party claims from transporting of a product or waste. Insuring Agreement 15 covers actual loss resulting from the interruption of the business operations caused solely and directly by on site pollution conditions. Actual loss means the net income the insured would have earned had there been no interruption. Coverage also includes loss of rental value, which generally means the anticipated rental income from tenant occupancy of insured property.

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

9. 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 to 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.

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

10. Special Risk – Regulatory Changes Insurance Policy.

Covers actual compliance expenses and any business interruption loss of up to 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.

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

11. Special Risk-Representation and Warranties Insurance Policy

Not insurance. The contract is vague as to what it covers. The documents provided do not provide enough information for us to be able to conclude that this contract is insurance in the commonly accepted sense.

12. Special Risk – Breach of Medical Standards Insurance Policy.

Covers all fines, penalties, defense expense and costs to bring operations in compliance resulting from an investigation or hearing of type brought by a public regulatory agency or private medical standards board. Types of investigations covered include but are not limited to allegations of HIPAA violations and medical standards reviews. Criminal acts not covered. Liability coverage is excluded.

Not Insurance. We cannot conclude that this contract is insurance in its commonly accepted sense. We need a better explanation of what the policy covers. For example, does the excluded liability coverage include negligence?

13. Special Risk – Tax Liability Insurance Policy.

Covers any additional tax liability up to \$0 subject to a deductible equal to 0% 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.

20XX

During 20XX, the taxpayer provided coverages under 15 direct contracts written by _____ and _____. Of the 15 contracts, the taxpayer participated in 12 of 13 contracts written in 20XX. Taxpayer eliminated the Special Risk – Representations and Warranties contract. However, during 20XX, the taxpayer added the Special Risk – Legal Expense Reimbursement contract,

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the Special Risk – Commercial Medical Malpractice contract, and the Excess Cyber Risk contract.

1. Special Risk Legal Expense Reimbursement Insurance Policy

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

Not Insurance. We cannot conclude that this contract is insurance in its commonly accepted sense. The policy is too vague as to what liability/contract underlies the need for defense expenses. Resembles Coverage Form B from Special Risk – Expense Reimbursement Insurance Policy (20XX).

2. Special Risk – Commercial Medical Malpractice Insurance Policy

Covers claims that have been denied by the listed insurance company, which issued the underlying medical malpractice insurance policy, due to a breach of warranty, failure to notify the insurer of medical operations or procedures, sales or distribution of excluded products, or the exhaustion of the primary limits.

Not Insurance. We cannot conclude that this contract is insurance in its commonly accepted sense. It is vague as to what it covers.

3. Excess Cyber Risk Insurance Policy

Insuring Agreement 1 – Cyber Risk Liability covers all damages that insured becomes legally obligated to pay and defense expenses as a result of any claim made against insured for a Wrongful Act. Wrongful Acts may include, but are not limited to the following: defamation; infringement of intellectual property; and failure to prevent unauthorized access to, use of, tampering with, or introduction of malicious code into data or systems.

Insuring Agreement 2 – 1st Party Property Loss & Business Interruption covers loss of or damages to insured's covered property caused by, but not limited to the following: a computer virus; a cyber attack, theft of computer system resources; and computer crimes. Insuring Agreement 2 also covers business interruption expenses, monies surrendered or costs incurred as a result of Cyber-Extortion, and reward money for information leading to the arrest and conviction of individuals committing or attempting to commit illegal acts related to coverage under the policy.

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Insuring Agreement 3 – Post-Loss Systems Crisis Management covers the cost of public relations services required to protect insured’s image and reputation following a covered loss. Insuring Agreement 3 also covers service fees of consultants hired to identify and/or implement ways to prevent or decrease the possibility of a further or future loss similar to the covered loss.

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

20XX

The taxpayer participated in, and provided coverage under the same 15 and direct written contracts as in 20XX.

20XX

The contracts for the 20XX tax year were not reviewed during the audit.

Our review of the direct written contracts executed during the tax years under consideration is summarized as follows:

Contract	Deemed Insurance	Deemed Not Insurance
Excess Directors & Officers	Yes	
Special Risk-Expense Reimbursement		No
Loss of Major Business to Business		No
Special Risk-Loss of Services		No
Special Risk-Punitive Wrap		No
Special Risk-Regulatory Changes		No
Special Risk-Tax Liability		No
Legal Expense Reimbursement		No
Special Risk- Excess Pollution		No
Special Risk – Loss of Major Customer		No
Excess Employment Practices		No
Excess Cyber Risk		No
Breach of Medical Standards		No
Special Risk-Collection Rate		No
Commercial Medical Malpractice		No
Special Risk-Payee Audit		No
Representations and Warranties		No

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We were able to definitively deem only one of the direct written contracts as insurance contracts because they included an insurance risk. Fourteen of the fifteen direct written and contracts were deemed not to include an insurance risk and was either a business or investment risk, or we were unable to clearly identify an insurance risk.

Other Insurance Policies

Quota Share Reinsurance Program.

participated in over 0 insurance policies with more than 0 insureds. blended together is 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 20XX reinsurance program, Taxpayer received a Quota Share reinsurance premium from in exchange for the assumption of 0% of the risk pool comprised of the stop loss coverages issued to all the stop loss endorsement policyholders (see also the Joint Underwriting Stop Loss Endorsement). In 20XX, taxpayer was identified as Reinsurer No. , and received a reinsurance premium from in exchange for the assumption of 0% of the risk pool. In 20XX, taxpayer was Reinsurer No. . Again, taxpayer received a reinsurance premium from in exchange for the assuming 0% of the risk pool.

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 15 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.

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Insurance In Its Commonly Accepted Sense

Staff

As a foreign corporation, taxpayer contracted with _____, in _____, to serve as its Residential Insurance Manager. Taxpayer did not hire or employ staff to conduct an insurance business. During the tax years under consideration, taxpayer did not incur salaries and wages expenses or any other payroll costs.

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 deemed to be "insurance" for federal tax purposes, the premium paid pursuant to that contract must be determined based on actuarial factors and principles. In Item #2 of the September 28, 20XX response to IDR #2, 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 20XX, 20XX, and 20XX. Thus, the Service concluded that the premiums received by taxpayer were not reasonable because they were not based on actuarial calculations and factors.

Use of Assets

Taxpayer engaged in investment activities that are typical of insurance companies. Based on the review of the Form 990 returns, taxpayer made _____ loans to the Affiliated Businesses to whom it executed the direct written contracts. Loans were made during the 20XX and 20XX tax years. The amount of the outstanding loan receivable balances represented the total percentage of assets as follows:

	12/31/20XX	12/31/20XX	12/31/20XX	12/31/20XX
Loan balance	-0-	\$ 0	\$ 0	-0-
Total Assets	\$ 0	\$ 0	\$ 0	\$ 0
Percentage	0%	0%	0%	0%

The Affiliated Businesses repaid the outstanding notes receivable balance to taxpayer during 20XX.

Risk Shifting

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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.

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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 0% of the total amounts it received during the tax year on a gross and net basis. Thus, 0% 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

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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 Situation 1 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 Situation 1. 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 contracts between the taxpayer and the Named Insureds: ; ; and , 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 partially-owned by a beneficial owner of the taxpayer, . Of total risk insured by the taxpayer, approximately 0% percent of the

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risk assumed during the years under audit is that of the affiliated businesses. In addition, of the total premiums received during the year, 0% percent of the premiums were derived from the direct written contracts that insure the risk of the affiliated businesses. Approximately 0% of all premiums and 0% of the direct written premiums were paid by three related entities, ; ; and . The taxpayer did not write, issue or sell direct written contracts as a Lead Insurer. Nor did the taxpayer write, issue or sell direct written contracts to non-affiliated business interests or to the general public. 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 of three insureds 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.

During the tax years under audit, the taxpayer was primarily and predominantly supported by direct written premiums that were received from three Affiliated Businesses. The taxpayer did not receive direct written premiums from an adequate pool of insureds. Thus, the contracts between the taxpayer and the Affiliated Business Interests, ; ; and , lacks the requisite risk distribution that is necessary for the contracts to be contracts of insurance, as described in Subchapter L of the Internal Revenue Code.

The Service concluded that the primary and predominant activity of the taxpayer is to assume risk from contracts that are solely concentrated in a limited number of policyholders, the affiliated businesses. Because the risk is too heavily concentrated in the Affiliated Businesses, it is clear that any losses paid by the taxpayer would be 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 businesses were paid primarily from the premiums paid to the taxpayer by the businesses. In other words, the arrangement between the taxpayer and the Affiliated Businesses represents 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 0% of the total risks assumed by the taxpayer is with affiliated businesses that are partially owned and controlled by , a beneficial owner of the taxpayer.

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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 for 20XX, twelve of the thirteen 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 twelve direct written contracts are not considered insurance premiums. The amount received by taxpayer for one of the thirteen direct written contracts was deemed to be a premium because only for this single contract included an insurance risk. For 20XX and 20XX, only one of the fifteen direct written contracts was deemed to include an insurance risk. The rest of the contracts were not insurance contracts because they did not coverage an insurance risk. The contracts covered either a business or investment risk. During the taxable years under consideration, _____ received amounts that the Service deemed to be direct written and reinsurance premiums as follows:

20XX				Premium
Contract				
Excess Directors & Officers Liability	\$	0	x	0%
				<u>\$ 0</u>
Amount Deemed Premiums from Direct Written Contracts				\$ 0
Quota Share Premiums				0
Credit Coinsurance Reinsurance				<u>0</u>
Total Premiums for 20XX				\$ 0
Gross Receipts for 20XX				0
Percentage of Premiums to Gross Receipts				0%

20XX				Premium
Contract				
Excess Directors & Officers Liability	\$	0	x	0%
				<u>\$ 0</u>
Amount Deemed Premiums from Direct Written Contracts				0
Quota Share Premiums				0
Credit Coinsurance Reinsurance				<u>0</u>
Total Premiums for 20XX				\$ 0

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Gross Receipts for 20XX	\$ 0
Percentage of Premiums to Gross Receipts	0%
20XX	
Contract	Premium
Excess Directors & Officers Liability	
\$ 0 x 0%	\$ 0
\$ 0 x 0%	0
Amount Deemed Premiums from Direct Written Contracts	\$ 0
Quota Share Premiums	0
Credit Coinsurance Reinsurance	0
Total Premiums for 20XX	\$ 0
Gross Receipts for 20XX	\$ 0
Percentage of Premiums to Gross Receipts	0%

20XX

Premiums received by taxpayer for each contract in 20XX was not requested during the examination.

The amounts received by _____ under the remaining contracts were not for insurance 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, the amount paid for each contract, by _____ ; _____ ; and _____ to the TP, do not qualify as an insurance premium.

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.

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During the tax years under consideration, the premium income received by taxpayer did not exceed 50% of its gross receipts. Gross receipts were computed under Notice 2006-42.⁵ Although gross receipts are less than the \$600,000 limitation, the amount deemed to be premiums, for each taxable year, is not more than 50% of gross receipts. Therefore, we are revising our position on the gross receipts test as stated in our Preliminary Report issued to taxpayer on March 13, 20XX. 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 any tax year under audit.

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 contracts with the Affiliated Businesses lack the requisite risk distribution. Therefore, the taxpayer does not qualify as an insurance company.

Application of Foreign Corporation Tax Provisions

The administrative file for the original Form 1024 application filed by _____ included a copy of the IRC 953(d) election filed by the Company on February 23, 20XX. However, the IRS has no record that the election was approved. As of the date of this examination, it appears that the Service still has not approved the IRC 953(d) election filed years ago. _____ withdrew the initial Form 1024 application on September 16, 20XX.

IRC 953(a)(1) defines insurance income to mean income which is attributable to the issuing or reinsuring of an insurance or annuity contract, and would be taxed under subchapter L if such income were the income of a domestic insurance company. Therefore, any premium income received by a CFC could qualify

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 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 company does not meet the requirements to make the IRC 953(d) election, and thus, is not a domestic corporation, the company should be treated as a "controlled foreign corporation," and the provisions of Subpart F of the Internal Revenue Code (sections 951-965) should apply. However, the Company did not generate any passive

⁵ Under Notice 2006-42, only gains from the sale of capital assets are included in gross receipts.

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sources of income such as dividends, interest, royalties, rents or annuities, during the tax year under audit.

The subpart F provisions apply to foreign corporations that qualify as controlled foreign corporations (“CFCs”). IRC 957 defines a CFC as a foreign corporation with regard to which more than 50% of the total combined voting power of all classes of stock entitled to vote or the total value of the stock is owned by U.S. shareholders. A U.S. shareholder, in turn, is defined under IRC 951(d) as a U.S. person who owns 10% or more of the total combined voting power of all classes of stock entitled to vote of the foreign corporation. Therefore, a corporation with regard to which more than 50% of the vote or value is owned by U.S. persons who individually own 10% or more of the vote will qualify as a CFC under IRC 957.

IRC 953(a)(1) defines insurance income to mean income which is attributable to the issuing or reinsuring of an insurance or annuity contract, and would be taxed under subchapter L if such income were the income of a domestic insurance company. Therefore, any premium income received by a CFC could qualify as insurance income for purposes of IRC 953 even though the CFC fails to qualify as an insurance company under subchapter L.

IRC 953(a)(2) of the Code excepts “exempt insurance income (as defined in subsection (e))” from the definition of insurance income. However, to qualify as exempt insurance income, such income must be derived by a qualifying insurance company. A qualifying insurance company is defined as a company that “is engaged in an insurance business and would be subject to tax under subchapter L if it were a domestic corporation.

IRC 953(e)(3)(C) states that income derived from U.S. sources does not qualify for exemption.

If a CFC does not qualify as an insurance company under subchapter L, it will not meet the definition of a qualifying insurance company for purposes of IRC 953(e). Thus, none of its insurance income will be exempt insurance income.

A Preliminary Report, Form 5701, *Notice of Proposed Adjustments*, was mailed to the taxpayer’s CPA, _____, on March 13, 20XX, proposing denial of tax-exempt treatment under section 501(c)(15) of the Internal Revenue Code, for the tax years ending December 31, 20XX, December 31, 20XX, and December 31, 20XX.

Finally, the Government contends that although the operations and financial records for the tax year ended December 31, 20XX, were not examined by TEGE, the taxpayer would also fail to qualify an insurance company for that year, if taxpayer operated in the same manner as that during the years audited.

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TAXPAYER'S POSITION:

A response to the Preliminary Report was received from _____, CPA, on May 17, 20XX. 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 Service's incorrect conclusion is based solely upon its unsupported and unsupportable position that _____ insurance operations lacked the requisite risk distribution.
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'd 979 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.

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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 the Service's analysis of risk distribution is incomplete. The Service ignores the numerous unrelated risks that insures. Courts have recognized that risk distribution can occur even with a single insured. The taxpayer cited, *Malone & Hyde v. Commissioner*.
8. Taxpayer argues that the Service merely asserts that risk distribution is lacking, instead of engaging in a meaningful analysis of the number of independent risk exposures insured by .
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).

Government's Response to Taxpayer's Position:

After reviewing the response to the Preliminary Report received from CPA, CPA, on May 17, 20XX, the Service's initial position is unchanged. primary and predominant business in tax years 20XX, 20XX, 20XX, and 20XX, was not insurance because the contracts issued by the company lacked the requisite risk distribution.

Taxpayer's Position:

In the second paragraph of the May 17, 20XX response to the agent's preliminary report, the CPA stated that the audit conclusion reached by the Service was solely based upon its unsupported and unsupportable position that insurance operations lacked the requisite risk distribution.

Government's Response:

The conclusion reached by the Service was based on an examination of the direct written and reinsurance contracts executed by , and books and records for the 20XX, 20XX, and 20XX tax years. Based on the review of the contracts, the Service concluded that the primary activity of was to assume risks of affiliated businesses owned and controlled by officers of and beneficial owners of the affiliated businesses. Approximately 0% of the risk

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assumed by _____ was that of the affiliated businesses. _____ did not assume risk of or receive direct written premiums from non-affiliated businesses or unrelated general public under the terms of the direct written contracts. The Service concluded that the direct written contracts lack the requisite risk distribution because arrangement does not include an adequate pool of related or unrelated insured for the law the large numbers to operate. The pool consisted of a single policyholder and payer of direct written premiums. Thus, primary and predominant activity is not insurance as described in Subchapter L of the Internal Revenue Code.

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 his argument that _____ qualifies as an insurance company. The CPA cited the court's holding, when a significant percentage (29 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 the remaining 71 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 1 on page 2 of the May 17, 20XX response:

In its preliminary report, the Service merely states, that due to 0 percent of premiums being direct written premiums for coverages written to four insureds, which in fact owned no interest in _____, there is a lack of adequate risk distribution. The Service's position ignores the fact that more than 0 percent of premiums were attributable to unrelated insurance arrangements involving many thousands of independent, unrelated risks of hundreds or thousands of unrelated insureds. The Service also ignores achieving distribution by issuing 28 policies to these four 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.

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Even if the CPA claimed that insurance exists under the rationale in the Harper case, where approximately 0% 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.

Taxpayer's Position:

On page 2, paragraph 5, 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:

The proper method for determining the amount of risk being assumed by the company is to compare the premiums received on the various contracts. Using the amounts reported on the Form 990 returns, the taxpayer assumed risks as follows:

20XX		
Direct Written Premiums	\$ 0	0%
Other Reinsurance Assumed	0	0%
Pooled Reinsurance Assumed	<u>0</u>	<u>0%</u>
Total	\$ 0	0.00%

20XX		
Direct Written Premiums	\$ 0	0%
Other Reinsurance Assumed	0	0
Pooled Reinsurance Assumed	<u>0</u>	<u>0</u>
Total	\$ 0	0.00%

20XX		
Direct Written Premiums	\$ 0	0%

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Other Reinsurance Assumed	0	0
Pooled Reinsurance Assumed	<u>0</u>	<u>0</u>
Total	\$ 0	0.00%

20XX		
Direct Written Premiums	\$ 0	0%
Other Reinsurance Assumed	0	0
Pooled Reinsurance Assumed	<u>0</u>	<u>0</u>
Total	\$ 0	0.00%

Under 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 0 percent of the business (and premiums) during the three years under audit.

Taxpayer's Position:

In paragraph 7, page 3, 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 or two insureds 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 50 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.

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Taxpayer's Position:

In the first paragraph on page 4 of the May 17, 20XX response, the CPA indicated that the Service did not engage in a meaningful analysis of the number of independent risk exposures insured by

Government's Response:

was incorporated on December 28, 20XX. The 20XX tax year was the taxpayer's first full year. In Item #5 of the January 3, 20XX response to IDR #2 for 20XX, the CPA indicated that paid out reinsurance losses of \$0 for the year. In Item #18 of the September 28, 20XX response to IDR #1, for the 20XX and 20XX tax years, the CPA indicated the taxpayer paid reinsurance losses of \$0 for 20XX, and \$0 for the 20XX tax year. In addition, the taxpayer set up reserves for claims received under the direct written contracts executed in 20XX and 20XX. One claim was received by taxpayer in 20XX, and six claims were received in 20XX. Four of the seven claims were filed jointly by all three of the Named Insureds. Three claims were filed by only one of the Named Insureds (). Under the direct written contracts, the taxpayer is one of four insurers responsible for providing the various coverages.

Under the terms of the direct written contracts, the insurers did not insure the risks of any unrelated third parties or the general public. Thus, if the Named Insureds filed claims, such claims would have been paid by premiums paid by only the Named Insureds. The taxpayer did not receive direct written premiums from any other sources during the tax years under audit.

Under the Quota Share reinsurance contract, the taxpayer was responsible for reinsuring minimum risks (less than 0% of total risks during the years under audit) incurred by . At least 50 other companies shared reinsuring the risks of under the pooling arrangement.

Taxpayer's Position:

In paragraph 2, on page 4, the CPA stated that 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 determination letters were issued to taxpayers 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.

Government's Position:

Each taxpayer stands alone. The audit of the activities and books and records of and the outcome of such audit stands alone. The issues raised by the Service with respect to the audit of are based on available facts.

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Taxpayer's Position:

In the last page of the May 17, 20XX response, 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, 20XX.

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, 20XX, after its Counsel anticipated that the Service would issue a final adverse ruling letter denying IRC 501(c)(15) exemption.

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 you do not qualify as an insurance company for federal income tax purposes, you fail to meet the requirements of section 501(c)(15) of the Code. Thus, you do 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 tax years ended December 31, 20XX, December 31, 20XX, December 31, 20XX, and December 31, 20XX.

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

Exhibit A
Deposit of Direct Written Premiums
20XX

Date of Deposit	Total Deposit			Total	
3/3/20XX	0			0	0
4/1/20XX	0			0	0
4/15/20XX	0				
5/5/20XX	0			0	0
6/2/20XX	0	0	0	0	0
7/2/20XX	0		0	0	0
7/24/20XX	0	0			0
8/4/20XX	0	0	0	0	0
8/26/20XX	0			0	0
8/28/20XX	0			0	0
8/31/20XX	(0)			(0)	(0)
9/10/20XX	(0)			(0)	(0)
9/14/20XX	0				
10/19/20XX	0			0	0
12/28/20XX	0			0	0
12/31/20XX				(0)	(0)

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Name of taxpayer	Tax Identification Number			Year/Period ended 12/31/20XX 12/31/20XX 12/31/20XX 12/31/20XX	

Totals 0 0 0 0 0

Exhibit B
Deposit of Direct Written Premiums
20XX

Date of Deposit	Total Deposit				Total
1/6/20XX	0				-
1/11/20XX	0	-	-	-	-
2/2/20XX	0				-
3/2/20XX	0				-
3/15/20XX	0		0	0	0
3/16/20XX	0		0		0
3/29/20XX	0			0	0
3/30/20XX	0	-	-	-	-
4/5/20XX	0			0	0
4/19/20XX	0			0	0
4/26/20XX	0	0	0	0	0
5/4/20XX	0				
5/10/20XX	0		0	0	0
5/14/20XX	0	0			0
6/3/20XX	0	0	0	0	0
6/3/20XX	0				-
6/28/20XX	0			0	0
7/6/20XX	0				-
7/13/20XX	0		0	0	0
7/14/20XX	0	0			0
8/3/20XX	0	0	0	0	0
8/23/20XX	0			0	0
9/8/20XX	0		0	0	0
9/15/20XX	0	-	-	-	-
9/13/20XX	0	0			0
10/4/20XX	0	0	0	0	0
10/31/20XX				0	0
11/2/20XX	0				-
11/2/20XX	0	-	-	-	-
12/6/20XX	0				-
Totals	0	0	0	0	0

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