Internal Revenue Service
Appeals Office

Department of the Treasury

Employer Identification Number:

Number: **201713012**
Release Date: 3/31/2017

Person to Contact:

Employee ID Number:
Tel:
Fax:

Date: September 15, 2016

Tax Period(s) Ended:

ORG
ADDRESS

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 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: June 10, 2013

Taxpayer Identification Number:

ORG
ADDRESS

Form:

Tax Period(s) Ended:

Person to Contact/ID Number:

Contact Numbers:
Telephone:
Fax:

Dear :

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

The attached revised Report of Examination, Form 886-A, summarizes the facts, the applicable law, and the Service's position regarding the examination of the tax periods listed above. This report supersedes our report dated January 15, 2013. You have not agreed with our determination, or signed a Form 6018-A, Consent to Proposed Action, accepting our determination of non-exempt status for the periods stated above. You have not agreed to file the required income tax returns. You may appeal your case. The enclosed Publication 3498, The Examination Process, and Publication 892, Exempt Organizations Appeal Procedures for Unagreed Issues, explain how to appeal an Internal Revenue Service

(IRS) decision. Publication 3498 also includes information on your rights as a taxpayer and the IRS collection process.

If you request a conference with Appeals, you must submit a written protest within 30 days of the date of this letter. An Appeals officer will review your case. The Appeals Office is independent of the Director, EO Examinations. Most disputes considered by Appeals are resolved informally and promptly.

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

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

You have the right to contact the office of the Taxpayer Advocate. Taxpayer Advocate assistance is not a substitute for established IRS procedures, such as the formal appeals process. The Taxpayer Advocate cannot reverse a legally correct tax determination, or extend the time fixed by law that you have to file a petition in a United States court. The Taxpayer Advocate can see that a tax matter that may not have been resolved through normal channels gets prompt and proper handling. You may call toll-free 1-877-777-4778 and ask for Taxpayer Advocate Assistance. If you prefer, you may contact your local Taxpayer Advocate at:

Taxpayer Advocate Service
7850 SW 6th Court, Room 265
Plantation, FL 33326
Ph: (954) 423-7677

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

ISSUE:

1. Whether the contracts executed by constitute contracts of insurance?
2. Whether the arrangement entered into by involves the requisite element of risk distribution?
3. Whether the primary and predominant business of is insurance?
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. Whether the IRC 953(d) election is invalid if is not an insurance company as described in Subchapter L of the Code?

FACTS:

("Taxpayer") was formed and incorporated in the Territory of the , on December 6, 20XX, under the provisions of the . 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. During 20XX and 20XX, the taxpayer was legally formed as a corporation.

In 20XX, the taxpayer filed a Certificate of Continuance to move its legal domicile from , to , . The Certificate of Continuance was approved by the Registrar of Companies, , , on July 1, 20XX.

Thus, since July 1, 20XX, the taxpayer is legally formed as an , corporation, under the provisions of the Companies Act, 2000, Section 197(1).

The taxpayer is wholly owned by , a limited liability company, located at . , as the sole shareholder, purchased 0 shares of the taxpayer's stock for $0 in December 20XX. is owned by (0% interest) and (0% interest). are 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, 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.

also co-equally own , and various other business interests collectively referred to as "Affiliated Businesses Interests." According to the Business Plan,

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

In addition to , also equally co-own , , , and .

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, signed an IRC 953(d) election statement on April 21, 20XX. It appears that the election statement was filed with the IRS , office on the same day. The IRC 953(d) election was approved by the IRS on July 10, 20XX, and commenced on December 10, 20XX.

On September 22, 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 tax year of the taxpayer. Prior to filing the Form 1024 application, the taxpayer had filed Form 1120-PC for its initial short tax year ended December 31, 20XX, with the Ogden Service Center. , President, signed the application on September 21, 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.

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

The Form 1024 application was referred to Rulings and Agreements in Washington, D.C., on October 29, 20XX, for consideration and ruling. The application was assigned to a Tax Law Specialist for review. On January 7, 20XX , the Tax Law Specialist issued a letter to the taxpayer requesting additional information about its operations to supplement the responses shown in the Form 1024 application. , President, submitted the requested information to the Tax Law Specialist on February 15, 20XX . No further action was taken on the application until September 20XX . Then, on September 20, 20XX , , President, sent a letter to the Tax Law requesting that the Form 1024 be withdrawn from 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.

The taxpayer filed Form 990-EZ for 20XX, claiming that it qualified as a tax-exempt small insurance company as described in IRC 501(c)(15). Calendar year 20XX was the taxpayer's first full tax year of operations. Form 990 returns were also filed for the 20XX and 20XX tax years.

The , , issued an initial Class 'B: General Insurance License to the taxpayer on December 10, 20XX. The license was renewed annually, thereafter. During the years under audit, the taxpayer operated primarily to provide property and casualty "insurance" coverage to the Affiliated Business Interests, which are co-owned by and , officers and beneficial owners of Supplemental information submitted with the Form 1024 application by the taxpayer revealed that own 0% co-equal ownership in the Affiliated Business Interests.

In 20XX, the taxpayer wrote nine (9) direct-written contracts to as follows: (1) Special Risk – Tax Liability, (2) Special Risk – Punitive Wrap; (3) Special Risk – Regulatory Changes, (4) Excess Pollution, (5) Special Risk – Loss of Major Customer, (6) Excess Employment Practices, (7) Excess Directors & Officers Liability, (8) Special Risk – Expense Reimbursement, and (9) Special Risk – Loss of Services. Each policy listed the Named Insureds as ; ; and , , located at . Each of the above-named policies is described in detail below.

Special Risk - Tax Liability

The Company is at risk from any adverse decision from an unexpected tax audit as regard positions taken on tax returns, e.g., deductibility of captive premiums, methods of accounting, etc.

Special Risk – Punitive Wrap Liability

Although the Company carries General Liability and Auto Liability coverage, those policies typically have numerous exclusions the insurers use to decline coverage. Any investigation, even if no negligence is found, could prove very costly. A policy to reimburse the Company for this type of insured defense expense may prove attractive to the Company.

Special Risk - Regulatory Changes

The Company is at risk of external factors such as regulatory changes in the construction sector. The Company could incur a significant outlay of monies to come into compliance with rules and regulations regarding its operations.

Excess Pollution Liability

The company is at risk for external factors relating to the disposal of hazardous waste at its principal place of business and at various construction job sites.

Loss of Major Business to Business Relationships

The Company's major business relationship is with . With such a high concentration of business tied to one business, the Company is at risk of significantly lower revenues if it loses this relationship during the time it arranges for alternate sources of income. Another area of concern is the additional expense needed to keep qualified independent contractors from moving to other companies during such a period.

Employment Practices Liability

The Company is potentially at risk for employment practices liability for discrimination, harassment, wrongful termination, or other similar inappropriate act. In some jurisdictions, actions related to civil rights allegations can come from third parties such as customers and independent contractors.

Directors & Officers Liability

An action against the directors and officers can come from a variety of sources, including the Company's primary customer, independent contractors, or other third parties if the Company's policies and procedures are alleged to be inappropriate or not followed adequately.

Expense Reimbursement

The Company may confront unanticipated expenses for public relations crisis management and uninsured defense expense. In the event of an allegation of liability for completed operations (similar to products liability for contractors), suspension of the Company's license, or other adverse event, significant monies could be required for public relations crisis management to avert and offset negative publicity which could ultimately lead to a loss of business.

Loss of Services

As a closely held corporation, the Company is highly dependent on the services of , the President, and , the Secretary. If the Company lost the services of either officer for an extended period of time, it would risk the loss of important business opportunities and face extensive costs finding a suitable replacement.

In each contract, the taxpayer is listed as the "Lead Insurer" (0%) and (0%) is listed as the "Stop Loss Insurer." Each contract listed . , and , , as the Named insureds. The contracts also listed policy period, premium payment due, aggregate risk insured, and coverages insured. The taxpayer did not write, issue, or sell direct contracts to unrelated third parties or the general public during 20XX. With respect of each of the 9 above referenced property and casualty contracts, the taxpayer and (" ") entered into an agreement titled, "Joint Underwriting Stop Loss Endorsement." The taxpayer and are separate independent companies and are not owned and controlled by related parties. Nor is related to shareholders, directors, or officers of the taxpayer. Under the terms of the agreement, the taxpayer is responsible for payment of claims up to certain specified thresholds. If the specified thresholds are met, then becomes liable for payment of claims up to certain specified limits. If the specified limits for payment of claims are exceeded, then the taxpayer again becomes liable. Under each of the 9 direct-written contracts, the taxpayer received 0% of the total premiums, and received 0% of the total premiums. Page 5, paragraph 4 of the agreement reads as follows:

> The premium rate for this Joint Underwriting Stop Loss Endorsement is 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.

Therefore, under the terms of the Joint Underwriting Stop Loss Endorsement agreement, was required to pay of total premiums of $0 for the nine direct written policies and for the stop loss endorsement. Of the total premium, paid $0 directly to the taxpayer (0%) as Lead Insurer. In addition, paid $0 as a reinsurance premium directly to , as the Stop Loss Insurer.

The taxpayer also entered into two types of reinsurance arrangements. The first arrangement is referred to as a "reinsurance risk pooling program." Under this arrangement, the taxpayer participated in a "reinsurance risk pool" with several other unrelated insurance companies ("pool participants"). The risk pool was operated by . Each pool participant had one or more affiliated operating entities for which it underwrites insurance coverage, generally casualty type coverage such as credit life and credit disability. insured a portion of the direct insurance underwritten by the pool participants using a so-called "stop loss" endorsement. participated in over 0 insurance policies with more than 0 insurers.

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 0 reinsurers participating in the Quota Share Reinsurance Program in 20XX. As Reinsurer # , the taxpayer received 0% of the Quota Share Retained 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 total reinsurance premiums of $0 to 0 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. The risk assumed under the quota share contract accounts for approximately 0% of the total risk assumed by the taxpayer.

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

Based on the current audit, the taxpayer's gross receipts were $0 for the 20XX tax year. Gross receipts were derived solely from premiums received from the direct written, reinsurance risk pooling program, and the . The taxpayer received gross receipts as follows:

	20XX	
Program Revenue Service		
Direct Written Premiums	$ 0	0%
Quota Share Reinsurance Premiums	0	0
Credit Coinsurance Reinsurance Premiums	0	0
Total Premiums	0	
Investment Income	0	0
Gain of sale of assets	-0-	-0-
Other income	0	0

Gross Receipts	$ 0	0.00%

The 20XX bank statements for taxpayer's checking account with revealed that the account was opened prior to 20XX, because the January 20XX statement reported a beginning balance. The premiums for the nine direct written contracts were paid by monthly. The taxpayer deposited the direct written premiums into the account. The bank statements reflected monthly deposits of $0 as direct written premiums.

Of the total premiums received by the taxpayer in 20XX, 0% of the premiums were generated from the nine direct written policies with the Affiliated Business Interests, ; 0% of the premiums are from the ; and 0% of the premiums from the .

As of December 31, 20XX, the taxpayer's assets totaled $0, and consisted primarily of cash and securities in its investment account ($0) and cash in its checking account ($0).

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. As of July 1, 20XX, the taxpayer legally moved its operations from the to the . The taxpayer wrote and issued tens contracts during the year. The ten contracts included the same nine contracts written in 20XX: (1) Special Risk – Tax Liability, (2) Special Risk – Punitive Wrap; (3) Special Risk – Regulatory Changes, (4) Excess Pollution, (5) Special Risk – Loss of Major Customer, (6) Excess Employment Practices, (7) Excess Directors & Officers Liability, (8) Special Risk – Expense Reimbursement, and (9) Special Risk – Loss of Services. The last contract written in 20XX was (10) Special Risk – Legal Expense contract. Each policy listed the Named Insureds as ; ; and , located at . All of the Named Insured continued to be Affiliated Business Interests owned and controlled by and , beneficial owners of the taxpayer. Each of the above-named policies is described in detail below.

Special Risk - Tax Liability

The Company is at risk from any adverse decision from an unexpected tax audit as regard positions taken on tax returns, e.g., deductibility of captive premiums, methods of accounting, etc.

Special Risk – Punitive Wrap Liability

Although the Company carries General Liability and Auto Liability coverage, those policies typically have numerous exclusions the insurers use to decline coverage. Any investigation,

even if no negligence is found, could prove very costly. A policy to reimburse the Company for this type of insured defense expense may prove attractive to the Company.

Special Risk - Regulatory Changes

The Company is at risk of external factors such as regulatory changes in the construction sector. The Company could incur a significant outlay of monies to come into compliance with rules and regulations regarding its operations.

Excess Pollution Liability

The company is at risk for external factors relating to the disposal of hazardous waste at its principal place of business and at various construction job sites.

Loss of Major Business to Business Relationships

The Company's major business relationship is with . With such a high concentration of business tied to one business, the Company is at risk of significantly lower revenues if it loses this relationship during the time it arranges for alternate sources of income. Another area of concern is the additional expense needed to keep qualified independent contractors from moving to other companies during such a period.

Employment Practices Liability

The Company is potentially at risk for employment practices liability for discrimination, harassment, wrongful termination, or other similar inappropriate act. In some jurisdictions, actions related to civil rights allegations can come from third parties such as customers and independent contractors.

Directors & Officers Liability

An action against the directors and officers can come from a variety of sources, including the Company's primary customer, independent contractors, or other third parties if the Company's policies and procedures are alleged to be inappropriate or not followed adequately.

Expense Reimbursement

The Company may confront unanticipated expenses for public relations crisis management and uninsured defense expense. In the event of an allegation of liability for completed operations (similar to products liability for contractors), suspension of the Company's license, or other adverse event, significant monies could be required for public relations crisis management to avert and offset negative publicity which could ultimately lead to a loss of business.

Loss of Services

As a closely held corporation, the Company is highly dependent on the services of , the President, and , the Secretary. If the Company lost the services of either officer for an

extended period of time, it would risk the loss of important business opportunities and face extensive costs finding a suitable replacement.

Legal Expenses Reimbursement

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

In each contract, the taxpayer is listed as the "Lead Insurer" and is listed as the "Stop Loss Insurer." As Lead Insurer, the taxpayer assumed 0% of the risks under the contracts. and the taxpayer executed a Joint Underwriting Stop Loss Endorsement, in which , as the Stop Loss Insurer, assumed the remaining 0% of the risks under the thirteen direct written contracts. The policy period for each contract is January 1, 20XX, through January 1, 20XX .

Under the terms of the direct written contracts, paid a total premium of $0. Of the total premium, $0 (or 0%) was paid directly to the taxpayer as a premium for the 10 direct written contracts and the $0 was paid directly to for the Stop Loss Coverage under the Joint Underwriting contract.

, ; and , the Affiliated Business Interests, are the only insured parties listed in each of the direct written contracts. During 20XX, the taxpayer did not write direct contracts with unrelated or unaffiliated parties. Nor did the taxpayer write direct contracts with the general public.

The direct written premiums received by the taxpayer were deposited into the account (#). In response to IDR #1, Question 7, for the 20XX and 20XX tax years, , CPA, provided a schedule listing the deposits of direct written premiums received by taxpayer from Construction, Inc., in 20XX, as follows:

Date of Deposit	Total Deposit	Direct Written Premium	Premium Finance Charge
02/24/20XX	$ 0	$ 0	$ 0
04/03/20XX	0	0	0
07/08/20XX	0	0	0
10/02/20XX	0	0	0
Totals	$ 0	$ 0	$ 0

Each deposit included a premium finance charge of $0 (totaling $0) that was assessed by the taxpayer because the Insured paid premiums monthly instead of on a single lump-sum payment. The examining agent verified the deposits with the 20XX statements during the audit. was the only payer of the quarterly direct written premiums and premium finance charges received by the taxpayer in 20XX.

Form 886-A (Rev. January 1994)	EXPLANATIONS OF ITEMS	Schedule number or exhibit
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The direct written premiums received by the taxpayer, under the ten direct written contracts in 20XX, accounted for approximately 0% of the total premiums received and assumed risk assumed by the taxpayer in 20XX.

In addition to writing the direct contracts, the taxpayer continued to participate in the quota share risk pooling reinsurance agreement with . The risk pool was operated by an unaffiliated corporation, (" "), which is a regulated insurer. Each pool participant had one or more affiliated operating entities for which it underwrites casualty type insurance coverage, such that for calendar 20XX, writes a Stop Loss endorsement on 0 insurance policies covering more than 0 insured. This includes policies issued by the taxpayer as well as those issued by the other pool participants that are unrelated insurance companies. As with the typical risk pooling arrangement, blended together its assumed risk coverages and then reinsured a quota share of these pooled risk with each of the pool participants. The end result of the pooling process was a more diversified book of risk coverages held by the taxpayer and by each of the other pool participants.

According to the terms of the 20XX Quota Share Reinsurance Policy executed with , the taxpayer was one of 0 companies listed as reinsurer. As Reinsurer # , the taxpayer receive 0% of its Quota Share Retained Premiums from in exchange for the assumption of 0% of the risk pool comprised of the stop loss coverages issued during the policy period by Insurance Company to all stop loss endorsement policyholders. paid total reinsurance premiums of $0 to 0 Reinsurers. Of this total premium, the taxpayer received a quota share reinsurance premium of $0, which was based on 0% of its share of risk assumed. According to the general ledger, the taxpayer reported receiving a reinsurance premium of $0 from in 20XX. The risk assumed under the quota share contract accounts for approximately 0% of the total risk assumed by the taxpayer

Finally, the taxpayer continued to participate in the credit coinsurance reinsurance program with in 20XX. The program involved the assumption of risks (that is, reinsurance assumed) from a third-party insurance company, which itself assumed such risks from other third party insurers, and which ultimately relates to a large pool of policies for vehicle service contracts that were directly written by a U.S. based insurance company, which served as the original ceding company. Under the terms of the contract, the taxpayer reinsured a 0% quota share of the risks from vehicle service contracts reinsured by . The vehicle service contracts were initially written by in 20XX, assumed by , and finally assumed by from . The taxpayer received a reinsurance premium of $0 from .

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. 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:

	20XX	
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
Gross Receipts	$ 0	0.00%

The 20XX bank statements for its checking account with reflected total deposits of $0 for the year. The statements did reflect deposit of direct written premium payments received by the taxpayer during the year.

Of the total premiums received by the taxpayer in 20XX, 0% of the premiums were generated for the ten direct written policies with the Affiliated Business Interest, 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 was a party to the same ten direct contracts as in the 20XX tax year: (1) Special Risk – Tax Liability, (2) Special Risk – Punitive Wrap; (3) Special Risk – Regulatory Changes, (4) Excess Pollution, (5) Special Risk – Loss of Major Customer, (6) Excess Employment Practices, (7) Excess Directors & Officers Liability, (8) Special Risk – Expense Reimbursement, and (9) Special Risk – Loss of Services. The last contract written in 20XX was (10) Special Risk – Legal Expense contract.

As was the case in 20XX and 20XX, all of the direct written contracts issued by the taxpayer in 20XX named ; ; and , located at , as the Named Insured. All of the Named Insured continued to be Affiliated Business Interests owned and controlled by and , beneficial owners of the taxpayer.

The following direct written contracts were executed by the taxpayer with the Affiliated Business Interests in 20XX :

Special Risk - Tax Liability
The Company is at risk from any adverse decision from an unexpected tax audit as regard positions taken on tax returns, e.g., deductibility of captive premiums, methods of accounting, etc.

Special Risk – Punitive Wrap Liability
Although the Company carries General Liability and Auto Liability coverage, those policies typically have numerous exclusions the insurers use to decline coverage. Any investigation, even if no negligence is found, could prove very costly. A policy to reimburse the Company for this type of insured defense expense may prove attractive to the Company.

Special Risk - Regulatory Changes
The Company is at risk of external factors such as regulatory changes in the construction sector. The Company could incur a significant outlay of monies to come into compliance with rules and regulations regarding its operations.

Excess Pollution Liability
The company is at risk for external factors relating to the disposal of hazardous waste at its principal place of business and at various construction job sites.

Loss of Major Business to Business Relationships
The Company's major business relationship is with . With such a high concentration of business tied to one business, the Company is at risk of significantly lower revenues if it loses this relationship during the time it arranges for alternate sources of income. Another area of concern is the additional expense needed to keep qualified independent contractors from moving to other companies during such a period.

Employment Practices Liability
The Company is potentially at risk for employment practices liability for discrimination, harassment, wrongful termination, or other similar inappropriate act. In some jurisdictions, actions related to civil rights allegations can come from third parties such as customers and independent contractors.

Directors & Officers Liability
An action against the directors and officers can come from a variety of sources, including the Company's primary customer, independent contractors, or other third parties if the Company's policies and procedures are alleged to be inappropriate or not followed adequately.

Expense Reimbursement
The Company may confront unanticipated expenses for public relations crisis management and uninsured defense expense. In the event of an allegation of liability for completed operations (similar to products liability for contractors), suspension of the Company's license, or other adverse event, significant monies could be required for public relations crisis management to avert and offset negative publicity which could ultimately lead to a loss of business.

Loss of Services
As a closely held corporation, the Company is highly dependent on the services of , the President, and , the Secretary. If the Company lost the services of either officer for an extended period of time, it would risk the loss of important business opportunities and face extensive costs finding a suitable replacement.

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

In each contract, the taxpayer is listed as the "Lead Insurer" and is listed as the "Stop Loss Insurer." As Lead Insurer, the taxpayer assumed 0% of the risks under the contracts. and the taxpayer executed a Joint Underwriting Stop Loss Endorsement, in which , as the Stop Loss Insurer, assumed the remaining 0% of the risks under the thirteen direct written contracts. The policy period for each contract is January 1, 20XX , through January 1, 20XX.

Under the terms of the direct written contracts, paid a total premium of $0. Of the total premium, $0 (or 0%) was paid directly to the taxpayer as a premium for the 0 direct written contracts and the $0 was paid directly to for the Stop Loss Coverage under the Joint Underwriting contract.

, ; and , the Affiliated Business Interests, are the only insured parties listed in each of the direct written contracts. During 20XX , the taxpayer did not write direct contracts with unrelated or unaffiliated parties. Nor did the taxpayer write direct contracts with the general public.

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

The direct written premiums received by the taxpayer were deposited into the account (#) In response to IDR #1, Question 7, for the 20XX and 20XX tax years, , CPA, provided a schedule listing the deposits of direct written premiums received by taxpayer from , in 20XX, as follows:

Date of Deposit	Total Deposit	Direct Written Premium	Premium Finance Charge
02/26/20XX	$ 0	$ 0	$ 0
03/15/20XX	0	0	0
04/30/20XX	0	0	0
05/07/20XX	0	0	0
06/23/20XX	0	0	0
07/29/20XX	0	0	0
08/24/20XX	0	0	0
09/30/20XX	0	0	0
10/27/20XX	0	0	0
11/19/20XX	0	0	0
Totals	$ 0	$ 0	$ 0

Each deposit included a premium finance charge of $0 (totaling $0) that was assessed by the taxpayer because the Insured paid premiums monthly instead of on a single lump-sum payment. The examining agent verified the deposits with the 20XX statements during the audit. was the only payer of the quarterly direct written premiums and premium finance charges received by the taxpayer in 20XX .

The direct written premiums received by the taxpayer, under the ten direct written contracts in 20XX, accounted for approximately 0% of the total premiums received and assumed risk assumed by the taxpayer in 20XX.

In addition to writing the direct contracts, the taxpayer continued to participate in the quota share risk pooling reinsurance agreement with . The risk pool was operated by an unaffiliated corporation, (" "), which is a regulated insurer. Each pool participant had one or more affiliated operating entities for which it underwrites casualty type insurance coverage, such that for calendar 20XX, writes a Stop Loss endorsement on 500± insurance policies covering more than 150± insured. This includes policies issued by the taxpayer as well as those issued by the other pool participants that are unrelated insurance companies. As with the typical risk pooling arrangement, blended together its assumed risk coverages and then reinsured a quota share of these pooled risk with each of the pool

participants. The end result of the pooling process was a more diversified book of risk coverages held by the taxpayer and by each of the other pool participants.

According to the terms of the 20XX Quota Share Reinsurance Policy executed with , the taxpayer was one of 0 companies listed as reinsurer. As Reinsurer #0, the taxpayer receive 0% of its Quota Share Retained Premiums 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. paid total reinsurance premiums of $0 to 0 Reinsurers. Of this total premium, the taxpayer received a quota share reinsurance premium of $0, which was based on 0% of its share of risk assumed. According to the general ledger, the taxpayer reported receiving a reinsurance premium of $0 from in 20XX . The risk assumed under the quota share contract accounts for approximately 0% of the total risk assumed by the taxpayer

Finally, the taxpayer continued to participate in the credit coinsurance reinsurance program with in 20XX . The program involved the assumption of risks (that is, reinsurance assumed) from a third-party insurance company, which itself assumed such risks from other third party insurers, and which ultimately relates to a large pool of policies for vehicle service contracts that were directly written by a based insurance company, which served as the original ceding company. Under the terms of the contract, the taxpayer reinsured a 0% quota share of the risks from vehicle service contracts reinsured by . The vehicle service contracts were initially written by in 20XX, assumed by , and finally assumed by from The taxpayer received a reinsurance premium of $0 from

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. 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:

	20XX	
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
Gross Receipts	$ 0	0.00%

The 20XX bank statements for its checking account with reflected total deposits of $0 for the year. The statements did reflect deposit of direct written premium payments received by the taxpayer during the year.

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

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

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.

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

Section 1.801-3 of the Income Tax Regulations provides that the term insurance company mean a company whose primary and predominant business activity during the taxable year is the issuing of insurance or annuity contracts or the reinsuring of risks underwritten by insurance companies. Thus, though its name, charter powers, and subjection to State insurance laws are significant in determining the business, which a company is authorized and intends to carry on, it is the character of the business actually done in the taxable year, which determines whether a company is taxable as an insurance company under the Code.

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-distributing" means that the party assuming the risk distributes his potential liability, in part, among others.

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

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

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

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

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

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

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

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

Foreign Corporation Tax Provisions

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

951(a) AMOUNTS INCLUDED. —

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

(A) the sum of —

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

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

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

IRC SEC. 953. INSURANCE INCOME.

953(a) INSURANCE INCOME. —

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

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

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

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

IRC SEC. 953 INSURANCE INCOME.

953(d) ELECTION BY FOREIGN INSURANCE COMPANY TO BE TREATED AS DOMESTIC CORPORATION.

(1) IN GENERAL. — If

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

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

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

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

GOVERNMENT'S POSITION:

Form 1024 Application

The taxpayer filed a Form 1024 application on September 22, 20XX, seeking retroactive exemption under IRC 501(c)(15), back to December 6, 20XX, the date of incorporation. The application was ultimately withdrawn by , President, on September 20, 20XX . The examining agent believes that the application was withdrawn by the company on the advice on its counsel, , , and , who are affiliated with , in , . The examining agent believes 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 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 Code nor the regulations define the terms "insurance" or "insurance contract." The standard for evaluating whether an arrangement constitutes insurance is Helvering v. LeGierse, 312 U.S. 531 (1941), in which the Court stated that 'historically and commonly insurance involves risk-shifting and risk-distributing in a transaction which involve(s) an actual 'insurance risk' at the time the transaction was executed." Insurance has been described as "involving a contract, whereby, for adequate consideration, one party agrees to indemnity another against loss arising from certain specified contingencies or perils. Empeir v. United States, 199 F.2d 508, 509-10 (7th Cir. 1952). Insurance is contractual security against possible anticipated loss. Id. Cases analyzing "captive insurance" arrangements have distilled the concept of "insurance" for federal income tax purposes to three elements, applied consistently with principles of federal income taxation: (1) involvement of an insurance risk; (2) shifting and distribution 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'q. 96 T.C. 18 (1991). The risk transferred must be risk of economic loss. Allied Fidelity Corp. v. Commissioner, 572 F.2d 1190, 1193 (7th Cir. 1978). The risk must contemplate the fortuitous occurrence of a stated contingency, Commissioner v. Treganowan, 183 F.2d 288, 290-91 (2d Cir. 1950), and must not be merely an investment or business risk. LeGierse, 312 U.S. at 542; Rev. Rul. 89-96.

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

Distributing risk allows the insurer to reduce the possibility that a single costly claim will exceed the amount taken in as premiums and set aside for the payment of such a claim. By assuming numerous relatively small, independent risks that occur over time, the insurer smoothes out

losses to match more closely its receipts of premiums. Clougherty Packing Co. v. Commissioner, 811 F.2d 1297, 1300 (9th Cir. 1987). Risk distribution necessarily entails a pooling of premiums, so that a potential insured is not in significant part paying for its own risks. See Humana, Inc. v. Commissioner, 881 F.2d 247, 257 (6th Cir. 1989).

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

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

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

The facts in Situation 2 of Rev. Ruling 2005-40 mirror the facts of Situation 1 except that in addition to its arrangement with the transport company, the carrier entered into a second

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

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

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

As discussed, the Service in Rev. Rul. 2002-90, concluded that insurance existed where 12 insureds each contributed between five and 15% to the insured's total risks. Similarly, in Situation 4 of Rev. Rul. 2005-40, the Service concluded that insurance existed where 12 LLCs, electing classification as associations, each contributed between five and 15% of the insurer's total risks. Moreover, in Situation 2 of Rev. Rul. 2002-89, supra, the Service concluded that insurance existed where a wholly owned subsidiary insured its parent, but the arrangement represented less than 50% of the insurer's total risk for the year.

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

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 direct written contracts between the taxpayer and ; ; and , the Named Insureds, do not constitute contracts of insurance because they lack the essential element of risk distribution. Most of the risk insured by the taxpayer is under the direct written contracts with affiliated businesses. The affiliated businesses are wholly-owned by beneficial owners of the taxpayer, and . Of total risk insured by the taxpayer, approximately 0% percent of the risk assumed during the years under audit is that of the affiliated business. In addition, of the total premiums received during the year, 0% percent of the premiums were derived from the direct written contracts that cover the risk of the affiliated businesses. Approximately 0% of all premiums and 0% of the direct written premiums were paid by a single entity, . The taxpayer did not write, issue or sell separate contracts to each of the Affiliated Businesses. Nor did the taxpayer receive separate premium payments from each of the Affiliated Businesses. No written agreement exists between the Affiliated Businesses that substantiates the portion of the direct written premium attributable to each business. Finally, the taxpayer did not sell direct written contracts to non-affiliated businesses or the general public.

During the tax years under audit, the taxpayer was primarily and predominantly supported by direct written premiums that were received from a single insured party, . 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, 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 too heavily concentrated in a single policyholder, . Because the risk is too heavily concentrated in an 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 paid the all of the direct written premiums received by the taxpayer during the years under audit, the Service concluded that losses incurred by the Affiliated Businesses were paid only from the premiums paid to the taxpayer by . 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.

Furthermore, it appears that the various risks insured are not homogeneous, and thus, must be separated from one another and analyzed separately as to whether there is risk distribution as to that risk. See. Rev. Rul. 2002-89, supra; also see Rev. Rul. 2005-40.

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 an affiliated entity that is owned and controlled by and , the beneficial owners of the taxpayer.

Likewise 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 lack the requisite risk distribution. Therefore, the taxpayer does not qualify as an insurance company.

The Service concluded that the IRC 953(d) election, which was approved by the Service, in July 20XX, is no longer valid because the taxpayer is not an insurance company within the meaning of Subchapter L of the Internal Revenue Code.

A Preliminary Report, Form 5701, *Notice of Proposed Adjustments*, was mailed to the taxpayer's CPA, , on September 28, 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.

TAXPAYER'S POSITION:
A response to the Preliminary Report was received from , CPA, on November 15, 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 position that insurance operations lacked the requisite risk distribution. 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.

2. The taxpayer indicated that "in analyzing captive insurance arrangements for the presence of risk distribution, courts have looked at the level of unrelated risk as a metric for the presence of risk distribution." The Service ignores the Tax Court ruling in *The Harper Group and Includible Subs. v Commissioner*, 96, T.C. 45 (1991), aff'd979 F.2d 1342 (9th Cir. 1992), where 0% unrelated risks was determined to be sufficient to meet the risk distribution requirement.

3. 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).

4. The taxpayer argues that the 0% outside business principle and the decision in *Harper* are recognized in the Service's own Foreign Insurance Excise Tax Audit Technique Guide.

5. 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.

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

7. Rather than engage in a meaningful analysis of the number of independent risk exposures insured by , the Service merely asserts that risk distribution is lacking. The Service has recognized the principle of looking-through the insurance

policy to the actual risks insured in several revenue rulings. See Rev. Rul. 20XX-26, Rev. Rul. 92-93, and Rev. Rul. 80-95.

8. 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).

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

Government's Response to Taxpayer's Position:

After reviewing the response to the Preliminary Report received from , CPA, on November 15, 20XX, the Service's initial position is unchanged. primary and predominant business in tax years 20XX, 20XX, and 20XX , was not insurance because the contracts issued by the company lacked the requisite risk distribution.

Taxpayer's Position:

In the initial paragraph of the November 15, 20XX response to the agent's preliminary report, the CPA stated that the audit conclusion reached by the Service was solely based on an unsupported 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 assumed by was that of the affiliated businesses. did not assume risk of or receive 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 the argument that qualifies as an insurance company. The CPA sites the court's holding, when a significant percentage (0 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 0 percent is irrelevant on the issue whether sufficient risk distribution is present because of the significant presence of unrelated risks. The CPA made the following statement in paragraph 2 on page 2 of the November 15, 20XX response:

> In its preliminary report, the Service merely states, that due to 0 percent of premiums being direct written premiums paid by certain insureds that owned no interest in , there is a lack of adequate risk distribution. This ignores the fact that more than 0 percent of premiums were attributable to unrelated insurance arrangements involving many thousands of independent, unrelated risks of hundreds or thousands of unrelated insureds.

Government's Response:

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

Even if the CPA claimed that insurance exists under the rationale in the Harper case, where approximately 0% of the risk assumed by was from unrelated or unaffiliated insured, 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 0 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 3, last paragraph, 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 before smaller risk-shifting arrangements qualify as insurance for federal income tax purposes. 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.

However, when the arrangements between the companies do constitute insurance for federal income tax purposes and assuming these arrangements represented more than 0 percent of the insuring company's business, the company will be an insurance company within the meaning of IRC Sections 816 and 831, and the premium payments may be deductible under Code Sec. 162, assuming the requirements for deduction are otherwise satisfied

Taxpayer's Position:
On page 4, paragraph 2, 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.

20XX			
Direct Written Premiums	$	0	0%
Other Reinsurance Assumed		0	0%
Pooled Reinsurance Assumed		0	0%
Total	$	0	0.00%

20XX			
Direct Written Premiums	$	0	0%
Other Reinsurance Assumed		0	0
Pooled Reinsurance Assumed		0	0
Total	$	0	0.00%

20XX			
Direct Written Premiums	$	0	0%
Other Reinsurance Assumed		0	0
Pooled Reinsurance Assumed		0	0
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:

On page 4, paragraph 3, the CPA stated that the Service's position is directly contrary to the position it has taken in hundreds of prior Section 501(c)(15) tax-exempt determination letters that it has issued. These favorable determination letters were issued to taxpayers substantially similar, or less favorable, facts to those of . There has been no intervening change in law to account for the Service's disparate tax treatment between and such similarly situated taxpayers. Accordingly, the Service has violated its own procedures and mandate to provide a uniform application of existing tax law. See Rev. Rul. 2012-9, Section 9.

Government's Response:

The Service's current position on captive arrangements is expressed in Revenue Ruling 2005-40, I.R.B. 2005-27 (June 17, 2005). Although the service has issued favorable rulings to

similar captive arrangements in the past, many of the rulings were issued prior to the publishing of Revenue Ruling 2005-40, and subsequent clarification of the revenue ruling received from the Office of Chief Counsel.

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

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

Taxpayer's Position:
On page 5, paragraph 2, 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 April 21, 20XX.

IRS records reveal that the IRC 953(d) election was never 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 20, 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 taxpayer did not qualify as an insurance company for federal income tax purposes, taxpayer failed to meet the requirements of section 501(c)(15) of the Code. Thus, taxpayer did not qualify for recognition of exemption under section 501(a) of the Code as an organization described in section 501(c)(15) of the Internal Revenue Code for the 20XX, 20XX, and 20XX tax years.

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