Internal Revenue Service
Appeals Office

Department of the Treasury

Employer Identification Number:

Person to Contact:

Number: **201713013**
Release Date: 3/31/2017

Employee ID Number:
Tel:
Fax:

Date: September 9, 2016

ORG
ADDRESS

Tax Period(s) Ended:

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 above.

Our adverse determination as to 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: May 9, 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 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

ISSUE:

1. Whether the contracts executed by constitute contracts of insurance?
2. Whether the arrangement entered into by involves the requisite element of risk distribution?
3. Whether more than half of the business of during each of the taxable years under consideration is the issuing of insurance or annuity contracts or the reinsuring of risks underwritten by insurance companies? See IRC Sections 831(c) and 816(a).
4. If is not an insurance company, does it qualify for treatment as a tax-exempt entity under section 501(c)(15) of the Internal Revenue Code?
5. Is treatment as an IRC 501(c)(15) tax exempt entity precluded if the organization does not have approval of its IRC 953(d) election?

FACTS:

("Taxpayer") was formed and incorporated in on December 18, 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 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). and 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 of the taxpayer.

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

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

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

On September 21, 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 990 for the tax year ended December 31, 20XX, with the Ogden Service Center. , President, signed the application on September 15, 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.

The Form 1024 application was referred to Rulings and Agreements in Washington, D.C., on October 27, 20XX, for consideration and ruling. The application was assigned to a Tax Law Specialist for review. No action was taken on the application until August 20XX. On August 3, 20XX, the Tax Law Specialist mailed a letter to the taxpayer's registered agent in . A copy of the letter was mailed to the taxpayer's attorney, . The letter requested additional information about the taxpayer's operations. The taxpayer's response to the letter was due by August 24, 20XX. , Attorney, submitted a letter dated August 19, 20XX, requesting an extension of time to respond until September 24, 20XX. The Attorney submitted a second letter dated September 16, 20XX, requesting another extension until October 24, 20XX.

Instead of responding to the additional information request of the Tax Law Specialist, the taxpayer's President, , submitted a letter dated September 20, 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 TE/GE 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 approved.

The taxpayer filed a Form 990-EZ return for its initial tax year that consisted of the period, December 24, 20XX (the effective date of its insurance license), through December 31, 20XX. The taxpayer also filed Form 990 for the 20XX and 20XX tax years. The 20XX tax year was the taxpayer's first full year of operation.

The Financial Services Commission, , issued a Class 'B: General Insurance License to the taxpayer effective December 24, 20XX. During the years under audit, the taxpayer operated primarily to provide property and casualty "insurance" coverage to , (dba), which is owned by , an officer and beneficial owner of Supplemental information submitted with the Form 1024 application by the taxpayer revealed that has 100% ownership interest in

In 20XX, the taxpayer wrote thirteen (13) direct-written contracts to as follows: (1) Special Risk – Breach of Medical Standards, (2) Special Risk –Collection Rate, (3) Excess Directors & Officers Liability, (4) Excess Employment Practices Liability, (5) Special Risk – Expenses Reimbursement, (6) Excess Intellectual Property Package, (7) Special Risk – Commercial Medical Malpractice GAP, (8) Special Risk – Loss of Services, (9) Excess Pollution Liability, (10) Special Risk – Punitive Wrap Liability, (11) Special Risk – Regulatory Changes, (12) Special Risk – Tax Liability, and (13) Unauthorized Treatment Liability. Each policy listed , located at , as the sole Named Insured. Although the Business Plan submitted by the taxpayer to the IRS with the Form 1024 application stated that the purpose of the taxpayer is to insure property and casualty risks of , and its related businesses, the 13 direct written contracts do not list any other entity except as the named insured. Each of the above-named policies is described in detail below.

Special Risk - Mishandling/Security Breach of Medical Records

is entrusted with, and manages, a large volume of sensitive personal medical 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 the Insureds. Taxpayer received premium of $0 for this contract.

Special Risk - Collections Rate

With current collections running over $0 annually, a drop in the collection rate of only a few percentage points, due to factors largely outside its control (e.g. levels of reimbursement by health insurers, pricing of services by third party payers, reduction in credit available for individual payers), would result in a significant decrease in revenue. Taxpayer received premium of $0 for this contract.

Excess Directors & Officers Liability

Action against the directors and officers may follow from the patients of the Company, referring physicians, managed care providers or other third parties if medical or billing procedures are alleged to be inappropriate. Taxpayer received premium of $0 for this contract.

Excess Employment Practices Liability

is potentially at risk for employment practices liability for discrimination, harassment, wrongful termination, or other similar inappropriate act. With a staff of 0 people and growing, turnover would seem inevitable which often turns into an EEOC complaint. The difficulties of addressing these issues in a growing practice are often more difficult than in a stabilized employment situation. Taxpayer received premium of $0 for this contract.

Special Risk - Expense Reimbursement

may confront unanticipated expenses for: (i) public relations crisis management and (ii) uninsured defense expense. In the event of a malpractice allegation, suspension of a physician's or medical support staff license, an unannounced government investigation/audit into billing procedures, or other adverse event, 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. To the extent that large billers of out of network facilities are examined, the Company and its affiliates are likely to be included. Taxpayer received premium of $0 for this contract.

Excess Intellectual Property Package

The contract provides indemnification subject to certain limitations to for all damages legally obligated to pay for litigation expenses, mitigation expenses, investigation expenses, costs to replace, restore, or re-create intellectual property, additional damages and rewards resulting from wrongful acts committed during the policy period. Wrongful acts include

infringement of copyright, plagiarism, investigation or interference of right of privacy or publicity; libel; slander; piracy or unfair competition; breach of contract; patent infringement; and malicious prosecution with regard to intellectual property. Taxpayer received premium of $0 for this contract.

Special Risk – Commercial Medical Malpractice Gaps

The Company maintains a professional liability policy through that contains several restrictive endorsements, including an exclusion of product liability on products sold by the Insured, punitive damages and material misrepresentations. Because of the range of services offered by the Company, the effectiveness of the coverages may not be intact. Taxpayer received premium of $0 for this contract.

Special Risk – Loss of Services

As a closely held corporation, is highly dependent on the services of , , , , , and . If the Company lost the services of any of its key employees for an extended period of time, it would risk the loss of important business opportunities and face extensive costs finding a suitable replacement. Taxpayer received premium of $0 for this contract.

Special Risk Pollution Liability

has a significant medical waste exposure that is excluded from its commercial general liability insurance coverage. It deals with "sharps" (used needles, etc.) and bodily fluids on a daily basis. Safe handling procedures are in place, however, there is no strict internal oversight so improper handling is possible. Taxpayer received premium of $0 for this contract.

Special Risk Punitive Wrap

The contract covers the failure of an insurer under the 12 other direct written contracts issued to 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 judicial ruling would otherwise be covered, and for which as insured is legally obligated to pay. Taxpayer received premium of $0 for this contract.

Regulatory Changes

is also at risk of some external factors such as regulatory changes, particularly since they are operating in a relatively marketing intensive delivery system of medical services. If any of the services becomes the subject of increased scrutiny from the FDA or the American Medical Association or if a physician who is neither Board certified or Board eligible is prevented from providing the called for care, would incur significant expenses to comply with additional regulations. Another change in regulation could require the procedures to be performed in any ambulatory surgery centers ("ASC") rather than in the doctor's office. Taxpayer received premium of $0 for this contract.

Tax Liability

is at risk if it were to suffer an adverse decision from an unexpected tax audit (e.g. with regard to organizational structure, accounting methodology or other federal tax related issues). Taxpayer received premium of $0 for this contract.

Unauthorized Treatments

employs physician assistants and nurses who may be motivated to use equipment, drugs and facilities to perform treatments on friends and/or family without authorization or oversight from . The vicarious liability for such activities represents an exposure to . Taxpayer received premium of $0 for this contract.

In each contract, the taxpayer is listed as the "Lead Insurer" (0%) and (0%) is listed as the "Stop Loss Insurer." With respect to the above direct written contracts, the taxpayer did not sale, write or issue direct written contracts to Named Insured other than . Each contract listed as the sole insured. The contracts also listed policy period, premium payment due, aggregate risk insured, and coverages insured. The taxpayer did not write direct contracts to unrelated third parties or the general public during 20XX. 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 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 13 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 thirteen 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± 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 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%

For the tax year ended December 31, 20XX, the taxpayer reported gross receipts of $0. 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 statement for its checking account with reveal that the taxpayer opened the account on December 16, 20XX, with a deposit of the $0 capital contribution received from its sole shareholder, . The only other deposits to the account during the tax year was a deposit of $0, on December 16, 20XX, which represented the payment of the direct written premium received from the Named Insured, , and interest income earned on December 23, 20XX, in the amount of $0.

Of the total premiums received by the taxpayer in 20XX, 0% of the premiums were generated from the thirteen direct written policies with the Affiliated Business Interest, . 0% of the premiums are from the Quota Share Reinsurance 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 cash in its checking account of $0.

20XX Tax Year

The 20XX tax year was the first full year of operations for the taxpayer. 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 thirteen (13) direct contracts to insure certain property and casualty risks of The taxpayer wrote many of the same direct contracts as was written in 20XX, with the exception of one. The taxpayer dropped the Excess Intellectual Property Package contract. This contract was replaced by a Special Risk Legal Expense Reimbursement contract. All of the direct written contracts issued by the taxpayer in 20XX named (dba) as the sole Named Insured. As in 20XX, , continued to be wholly owned (100%) by a beneficial owner of the taxpayer, .

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

Special Risk - Mishandling/Security Breach of Medical Records

is entrusted with, and manages, a large volume of sensitive personal medical 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 the Insureds. Taxpayer received premium of $0 for this contract.

Special Risk - Collections Rate

With current collections running over $0 annually, a drop in the collection rate of only a few percentage points, due to factors largely outside its control (e.g. levels of reimbursement by health insurers, pricing of services by third party payers, reduction in credit available for individual payers), would result in a significant decrease in revenue. Taxpayer received premium of $0 for this contract.

Excess Directors & Officers Liability

Action against the directors and officers may follow from the patients of the Company, referring physicians, managed care providers or other third parties if medical or billing procedures are alleged to be inappropriate. Taxpayer received premium of $0 for this contract.

Excess Employment Practices Liability

is potentially at risk for employment practices liability for discrimination, harassment, wrongful termination, or other similar inappropriate act. With a staff of 0 people and growing, turnover would seem inevitable which often turns into an EEOC complaint. The difficulties of addressing these issues in a growing practice are often more difficult than in a stabilized employment situation. Taxpayer received premium of $0 for this contract.

Special Risk - Expense Reimbursement

may confront unanticipated expenses for: (i) public relations crisis management and (ii) uninsured defense expense. In the event of a malpractice allegation, suspension of a physician's or medical support staff license, an unannounced government investigation/audit into billing procedures, or other adverse event, 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. To the extent that large billers of out of network facilities are examined, the Company and its affiliates are likely to be included. Taxpayer received premium of $0 for this contract.

Special Risk – Expense Reimbursement – Legal Expenses Insurance Policy
The contract covers certain litigation expenses incurred by the resulting from their actual or alleged civil liability in excess of $0 to mitigate costs to , such as defense expenses; lost work time; cost to hire independent counsel; and expert witness fees and travel expenses. Taxpayer received premium of $0 for this contract.

Special Risk – Commercial Medical Malpractice Gaps
The Company maintains a professional liability policy through that contains several restrictive endorsements, including an exclusion of product liability on products sold by the Insured, punitive damages and material misrepresentations. Because of the range of services offered by the Company, the effectiveness of the coverages may not be intact. Taxpayer received premium of $0 for this contract.

Special Risk – Loss of Services
As a closely held corporation, is highly dependent on the services of , , , , , and . If the Company lost the services of any of its key employees for an extended period of time, it would risk the loss of important business opportunities and face extensive costs finding a suitable replacement. Taxpayer received premium of $0 for this contract.

Special Risk Pollution Liability
has a significant medical waste exposure that is excluded from its commercial general liability insurance coverage. It deals with "sharps" (used needles, etc.) and bodily fluids on a daily basis. Safe handling procedures are in place, however, there is no strict internal oversight so improper handling is possible. Taxpayer received premium of $0 for this contract.

Special Risk Punitive Wrap
The contract covers the failure of an insurer under the 12 other direct written contracts issued to 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 judicial ruling would otherwise be covered, and for which as insured is legally obligated to pay. Taxpayer received premium of $0 for this contract.

Regulatory Changes
is also at risk of some external factors such as regulatory changes, particularly since they are operating in a relatively marketing intensive delivery system of medical services. If any of the services becomes the subject of increased scrutiny from the FDA or the American Medical Association, or if a physician who is neither Board certified or Board eligible is prevented from providing the called for care, would incur significant expenses to comply with additional regulations. Another change in regulation could require the procedures

to be performed in any ambulatory surgery centers ("ASC") rather than in the doctor's office. Taxpayer received premium of $0 for this contract.

Tax Liability

is at risk if it were to suffer an adverse decision from an unexpected tax audit (e.g. with regard to organizational structure, accounting methodology or other federal tax related issues). Taxpayer received premium of $0 for this contract.

Unauthorized Treatments

employs physician assistants and nurses who may be motivated to use equipment, drugs and facilities to perform treatments on friends and/or family without authorization or oversight from . The vicarious liability for such activities represents an exposure to . Taxpayer received premium of $0 for this contract.

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 (0%) was paid directly to the taxpayer as a premium for the 13 direct written contracts and the $0 was paid directly to for the Stop Loss Coverage under the Joint Underwriting contract.

, the affiliated business interest, is the only insured party 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 checking account (#0). 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 from the taxpayer, in 20XX, as follows:

Date of Deposit	Amount
01/29/20XX	$ 0
02/26/20XX	0
03/27/20XX	0
04/17/20XX	0
05/01/20XX	0
Total Premium	$ 0

The examining agent verified the deposits with the 20XX bank statements during the audit.

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

In 20XX, the taxpayer also received premium finance charges of $0 from . The finance charges were assessed by the taxpayer because , paid the direct written premiums monthly, and not by a single lump sum premium payment.

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± insureds. This includes policies issued by the taxpayer as well as those issued by the other pool participants that are unrelated insurance companies. As with the typical risk pooling arrangement, blended together its assumed risk coverages and then reinsured a quota share of these pooled risk with each of the pool participants. The end result of the pooling process was a more diversified book of risk coverages held by the taxpayer and by each of the other pool participants. According to the terms of the 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 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 thirteen direct written policies with the Affiliated Business Interest, ; 0% of the premiums are from the Quota Share Reinsurance Risk 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.

However, instead of 13 direct contracts written, the taxpayer wrote fourteen (14) direct contracts, in 20XX, to insure certain property and casualty risks of The taxpayer wrote many of the same 13 direct contracts as was written in 20XX, plus an additional Commercial Medical Malpractice Gap contract (GP-) to

As was the case in 20XX and 20XX, all of the direct written contracts issued by the taxpayer in 20XX named (dba) as the sole Named Insured. , continued to be wholly owned (0%) by a beneficial owner of the taxpayer, .

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

Special Risk - Mishandling/Security Breach of Medical Records

is entrusted with, and manages, a large volume of sensitive personal medical 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 the Insureds. Taxpayer received premium of $0 for this contract.

Special Risk - Collections Rate

With current collections running over $0 annually, a drop in the collection rate of only a few percentage points, due to factors largely outside its control (e.g. levels of reimbursement by health insurers, pricing of services by third party payers, reduction in credit available for individual payers), would result in a significant decrease in revenue. Taxpayer received premium of $0 for this contract.

Excess Directors & Officers Liability

Action against the directors and officers may follow from the patients of the Company, referring physicians, managed care providers or other third parties if medical or billing procedures are alleged to be inappropriate. Taxpayer received premium of $0 for this contract.

Excess Employment Practices Liability

is potentially at risk for employment practices liability for discrimination, harassment, wrongful termination, or other similar inappropriate act. With a staff of 0 people and growing, turnover would seem inevitable which often turns into an EEOC complaint. The difficulties of addressing these issues in a growing practice are often more difficult than in a stabilized employment situation. Taxpayer received premium of $0 for this contract.

Special Risk - Expense Reimbursement

may confront unanticipated expenses for: (i) public relations crisis management and (ii) uninsured defense expense. In the event of a malpractice allegation, suspension of a physician's or medical support staff license, an unannounced government investigation/audit into billing procedures, or other adverse event, 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. To the extent that large billers of out of network facilities are examined, the Company and its affiliates are likely to be included. Taxpayer received premium of $0 for this contract.

Special Risk – Expense Reimbursement – Legal Expenses Insurance Policy

The contract covers certain litigation expenses incurred by the resulting from their actual or alleged civil liability in excess of $0 to mitigate costs to , such as defense expenses; lost work time; cost to hire independent counsel; and expert witness fees and travel expenses. Taxpayer received premium of $0 for this contract.

Special Risk – Commercial Medical Malpractice Gap #101

The Company maintains a professional liability policy through that contains several restrictive endorsements, including an exclusion of product liability on products sold by the Insured, punitive damages and material misrepresentations. Because of the range of services offered by the Company, the effectiveness of the coverages may not be intact. Taxpayer received premium of $0 for this contract.

Special Risk – Commercial Medical Malpractice Gap #102

The contract provides "exclusion/endorsement buy back" or "differences in conditions" coverage for a covered event from an underlying commercial property, commercial general liability, or other commercial insurance Policy name and number: Special Risk – Commercial Medical Malpractice Gap; ; Policy #); Policy Period 1/1/20XX to 1/1/20XX; $0 Each Claim/Aggregate Limit. Taxpayer received premium of $0 for this contract.

Special Risk – Loss of Services

As a closely held corporation, is highly dependent on the services of , , , , , and . If the Company lost the services of any of its key employees for an extended period of time, it would risk the loss of important business opportunities and face extensive costs finding a suitable replacement. Taxpayer received premium of $0 for this contract.

Special Risk Pollution Liability

has a significant medical waste exposure that is excluded from its commercial general liability insurance coverage. It deals with "sharps" (used needles, etc.) and bodily fluids on a daily basis. Safe handling procedures are in place, however, there is no strict

internal oversight so improper handling is possible. Taxpayer received premium of $0 for this contract.

Special Risk Punitive Wrap

The contract covers the failure of an insurer under the 12 other direct written contracts issued to 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 judicial ruling would otherwise be covered, and for which as insured is legally obligated to pay. Taxpayer received premium of $0 for this contract.

Regulatory Changes

is also at risk of some external factors such as regulatory changes, particularly since they are operating in a relatively marketing intensive delivery system of medical services. If any of the services becomes the subject of increased scrutiny from the FDA or the American Medical Association, or if a physician who is neither Board certified or Board eligible is prevented from providing the called for care, would incur significant expenses to comply with additional regulations. Another change in regulation could require the procedures to be performed in any ambulatory surgery centers ("ASC") rather than in the doctor's office. Taxpayer received premium of $0 for this contract.

Tax Liability

is at risk if it were to suffer an adverse decision from an unexpected tax audit (e.g. with regard to organizational structure, accounting methodology or other federal tax related issues). Taxpayer received premium of $0 for this contract.

Unauthorized Treatments

employs physician assistants and nurses who may be motivated to use equipment, drugs and facilities to perform treatments on friends and/or family without authorization or oversight from . The vicarious liability for such activities represents an exposure to . Taxpayer received premium of $0 for this contract.

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% of total premium) was paid directly to the taxpayer as a premium for the 14 direct written contracts and the $0 (or 0%) was paid directly to for the Stop Loss Coverage under the Joint Underwriting contract.

, the affiliated business interest, is the only insured party 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 checking 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 the taxpayer from , in 20XX, as follows:

Date of Deposit	Amount
02/19/20XX	$ 0
03/23/20XX	0
03/23/20XX	0
04/28/20XX	0
05/28/20XX	0
06/21/20XX	0
07/09/20XX	0
09/10/20XX	0
10/01/20XX	0
10/25/20XX	0
Total Premium	$ 0

The examining agent verified the deposits with the 20XX bank statements during the audit.

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

In 20XX, the taxpayer also received premium finance charges of $0 from . The finance charges were assessed by the taxpayer because paid the direct written premiums monthly, and not by a single lump sum premium payment. The taxpayer received a monthly premium finance charge of $0 included with each monthly payment. Basically, the taxpayer received a total of $0 each month from , of which $0 was the direct written premium and $0 was for the premium finance charge.

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± insureds. This includes policies issued by the taxpayer as well as those issued by the other pool participants that are unrelated insurance

companies. As with the typical risk pooling arrangement, blended together its assumed risk coverages and then reinsured a quota share of these pooled risk with each of the pool participants. The end result of the pooling process was a more diversified book of risk coverages held by the taxpayer and by each of the other pool participants. According to the terms of the 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 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 thirteen 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.

Taxpayer also filed Form 990 for the tax year ended December 31, 20XX, continuing to claim IRC 501(c)(15) tax-exempt status. The 20XX tax year was not examined by TEGE.

LAW:

Section 501(c)(15) of the Internal Revenue Code provides insurance companies 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.

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.

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

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 21, 20XX, seeking retroactive exemption under IRC 501(c)(15), back to December 18, 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 Internal Revenue Code nor the Income Tax Regulations define the terms "insurance" or "insurance contract." The standard for evaluating whether an arrangement constitutes insurance for federal tax purposes has evolved over the years and is, at best, a nonexclusive facts and circumstances analysis. Sears, Roebuck and Co. v. Commissioner, 972 F.2d 858, 861-64 (7th Cir. 1992). The most frequently cited opinion on the definition of insurance is Helvering v. LeGierse, 312 U.S. 531 (1941), in which the Court describes "insurance" as an arrangement involving risk-shifting and risk-distributing of an actual "insurance risk" at the time the transaction was executed. Cases analyzing "captive insurance" arrangements have described the concept of "insurance" for federal income tax purposes as containing three elements: (1) involvement of an insurance risk; (2) shifting and distributing of

that risk; and (3) insurance in its commonly accepted sense. See e.g., AMERCO, Inc. v. Commissioner, 979 F.2d 162, 164-65 (9th Cir. 1992), aff'g. 96 T.C. 18 (1991). The test, however, is not a rigid three-prong test.

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

Not all contracts that transfer risk are insurance policies even where the primary purpose of the contract is to transfer risk. For example, a contract that protects against the failure to achieve a desired Investment return protects against Investment risk, not insurance risk. LeGierse, 312 U.S. at 542 (the risk must not be merely an Investment risk); Securities and Exchange Commission v. United Benefit Life Insurance Co., 387 U.S. 202, 211 (1967) (the transfer of an Investment risk cannot by itself create insurance). See also, Rev. Rul. 89-96, 1989-2 C.B. 114 (risks transferred were in the nature of Investment risk, not insurance risk); Rev. Rul. 68-27, 1968-1 C.B. 315 (although an element of risk existed, it was predominantly a normal business risk of an organization engaged in furnishing medical services on a fixed price basis rather than an insurance risk) and Rev. Rul. 2007-47, 2007-2 C.B. 127 (the arrangement lacked the requisite insurance risk to constitute insurance because the arrangement lacked fortuity and the risk at issue was akin to the timing and Investment risks of Rev. Rul. 89-96).

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

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

FINANCIAL ECONOMICS WITH APPLICATIONS TO INVESTMENTS, INSURANCE AND PENSIONS 1 (Harry H. Panier, ed., 2001).

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

Lack of Insurance Risk

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

1. 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.

We could not conclude that this contract is insurance in the commonly accepted sense. The contract is vague as to what it covers.

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

2. 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.

3. Excess Directors & Officers Liability Insurance Policy.

Covers wrongful acts of directors and officers.

Insurance.

4. 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., investigation 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. Policy is not insurance in its commonly accepted sense. There is no insurance risk but only Investment or business risk.

5. Special Risk – Expense Reimbursement Insurance Policy.

Coverage Form A deals with crisis management public relations expenses. This covers all public relations expenses to mitigate the insured's adverse publicity generated from an actual or imminent: liability incident that could exceed $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 as to Coverage A. Coverage Form A is not insurance in the commonly accepted sense. There is no insurance risk but only Investment or business risk.

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

6. Excess Intellectual Property Package Policy.

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

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

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

7. Special Risk – Commercial Medical Malpractice Gap 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.

We could not conclude that this contract is insurance in the commonly accepted sense. The contract is vague as to what it covers.

8. Special Risk – Loss of Services Insurance Policy.

Covers the involuntary loss of services for 0 employees. The covered cause of loss must be involuntary and includes sickness, disability, death, loss of license, resignation or retirement after 0 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.

9. 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.

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.

10. 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. The schedule of covered policies lists the other 12 policies described in this part of this memorandum.

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 – 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.

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

12. 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.

13. Unauthorized Treatment Liability Insurance Policy.

Covers compensatory damages because of injury arising out of any unauthorized treatment, which is defined as any medical procedure performed by a medical assistant, staff, intern etc. without the insured's knowledge, consent or supervision.

Insurance. Policy covers risks similar to risks in commonly accepted insurance contracts.

20XX Policies

Same as 20XX except Excess Intellectual Property replaced with:

Expense Reimbursement – Legal Expenses Insurance Policy.

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

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

20XX Policies

Same as the 13 polices written in 20XX plus:

Commercial Insurance Gap Policies

There are two policies that reimburse for losses denied solely and exclusively due to the exclusion, endorsement, or limitation specified in their applicable underlying policy listed as Commercial Medical Malpractice Gap ( ) and ( ).

We could not conclude that this contract is insurance in the commonly accepted sense. The contract is vague as to what it covers.

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

Contract	Deemed Insurance	Not Deemed Insurance
Special Risk-Breach of Medical Standards		No
Special Risk-Collection Rate		No
Excess Directors & Officers	Yes	
Excess Employment Practices		No
Special Risk-Expense Reimbursement		No
Excess Intellectual Property Package		No
Special Risk-Loss of Services		No
Special Risk-Commercial Medical Malpractice		No
Excess Pollution		No
Special Risk-Punitive Wrap		No
Special Risk-Regulatory Changes		No
Special Risk-Tax Liability		No
Unauthorized Treatments	Yes	
Legal Expense Reimbursement		No

We were able to definitively deem two of the direct written contracts as insurance contracts because they included an insurance risk. Twelve of the fourteen direct written 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 0% of premiums 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. , received 0% of premiums in exchange for the assumption of 0% of the risk pool. In 20XX, taxpayer was Reinsurer No. . Again, taxpayer received 0% of premiums 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 13 contracts written by . Therefore, it is highly likely that the entire pool, which is insured by and reinsured on a quota share basis with each of the pool participants, is primarily comprised of direct written contracts that the Service would deem not be insurance in the commonly

accepted sense. Thus all or a portion of the premiums received by taxpayer, during the taxable years under consideration, would not be for reinsuring insurance risks.

Credit Coinsurance Reinsurance Program.

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

Pricing of Contracts

The Service also has concern about whether the premiums charged for the contracts were reasonable. A premium for an insurance contract is based on actuarial calculations and factors. Even if an insurance contract is deem to be "insurance" for federal tax purposes, the premium paid pursuant to that contract must be determined based on actuarial factors and principles. In the February 24, 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.

Risk Shifting

Risk shifting occurs if a person facing the possibility of an economic loss transfers some or all of the financial consequences of the potential loss to the insurer, such that a loss by the insured does not affect the insured because the loss is offset by a payment from the insurer. See Rev. Rul. 60-275 (risk shifting not present where subscribers, all subject to the same flood risk, agreed to coverage under a reciprocal flood insurance exchange).

Risk Distribution

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

assuming the risk distributes his potential liability, in part, among others"); Ocean Drilling & Exploration Co. v. United States, 988 F.2d 1135, 1135 (Fed. Cir. 1993) ("risk distribution involves spreading the risk of loss among policyholders").

Distributing risk allows the insurer to reduce the possibility that a single costly claim will exceed the amount taken in as premiums and set aside for the payment of such a claim. By assuming numerous relatively small, independent risks that occur over time, the insurer smoothes out losses to match more closely its receipts of premiums. Clougherty Packing Co. v. Commissioner, 811 F.2d 1297, 1300 (9th Cir. 1987). Risk distribution necessarily entails a pooling of premiums, so that a potential insured is not in significant part paying for its own risks. See Humana, Inc. v. Commissioner, 881 F.2d 247, 257 (6th Cir. 1989).

In Situation 1 of Rev. Rul. 2002-89, S, a wholly owned subsidiary of P, a domestic parent corporation, entered into an annual arrangement with P whereby S provided coverage for P's professional liability risks. The liability coverage S provided to P accounted for 90% of the total risks borne by S. Under the facts of Situation 1, the Service concluded that insurance did not exist for federal income tax purposes. On the other hand, in Situation 2 of Rev. Rul. 2002-89, the premiums that S received from the arrangement with P constituted less than 50% of total premiums received by S for the year. Under the facts of Situation 2, the Service reasoned that the premiums and risks of P were pooled with those of unrelated insureds and thus the requisite risk shifting and risk distribution were present. Accordingly, under Situation 2, the arrangement between P and S constituted insurance for federal income tax purposes.
In Rev. Rul. 2002-90, S, a wholly owned insurance subsidiary of P, directly insured the professional liability risks of 12 operating subsidiaries of its parent. S was adequately capitalized and there were no related guarantees of any kind in favor of S. Most importantly, S and the insured operating subsidiaries conducted themselves in a manner consistent with the standards applicable to an insurance arrangement between unrelated parties. Together, the 12 operating subsidiaries had a significant volume of independent, homogeneous risks. Under the facts presented, the ruling concludes the arrangement between S and each of the 12 operating subsidiaries of the parent of S constitute insurance for federal income tax purposes.

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

distributed among other insured's or policyholders. Therefore, the arrangement between the carrier and the transport company did not constitute insurance for federal income tax purposes.

The facts in Situation 2 of Rev. Ruling 2005-40 mirror the facts of Situation 1 except that in addition to its arrangement with the transport company, the carrier entered into a second arrangement with another unrelated domestic company. In the second arrangement, the carrier agreed that in exchange for "premiums," it would "insure" the second company against its risk of loss associated with the operation of its own transport fleet. The amount that the carrier received from the second agreement constituted 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 0 and 0% 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 0% 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 0% 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 0% of the total risks borne by the subsidiary. Similarly, in Situation 2 of Rev. Rul. 2005-40, supra, a second insurer contributing 0% of the insured's risks was added to the single-insured scenario of Situation1. The Service concluded in both of the above scenarios that insurance did not exist because there lacked a sufficient number of insureds. The small number of insureds produced an insufficient pool of premiums to distribute any insurance risk.

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

With respect to the contracts reviewed during the tax years under audit, the Service concluded that the agreements between the taxpayer and the sole Named Insured, do not constitute contracts of insurance because the risk transferred is a business or Investment risk and not an insurance risk; and the contracts lack the essential element of risk distribution. Most of the risk insured by the taxpayer is under the direct written contracts with an affiliated business. The affiliated business is wholly-owned by a beneficial owner of the taxpayer, . 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. Rev. Rul. 2005-40 cited several court decisions that have recognized that risk distribution necessarily entails a pooling of premiums, so that a potential insured is not in significant part paying for its own risks. In this case, the large concentration of insurance risks in one insured does not constitute risk distribution because of the very high likelihood of the insured paying for any of its claims with its own premiums. Such an arrangement is not insurance but a form of self-insurance.

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 business. Approximately 0% of all premiums and 100% of the direct written premiums were paid by a single entity, did not write, issue or sell direct written contracts to non-affiliated business interests. Nor did the taxpayer sell direct written contracts to 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 Interest, , 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 single policyholder, , an affiliated business interest. Because the risk is too heavily concentrated in an Affiliated Business, it is clear that any losses paid by the taxpayer would be those of the Affiliated Business and not from an unrelated third party. In addition, since paid the majority of premiums received by the taxpayer during the years under audit, the Service concluded that losses incurred by were paid only from the premiums paid to the taxpayer by . In other words, the arrangement between the taxpayer and the Affiliated Business, , represents a form of self-insurance, and no court has held that self-insurance is insurance for federal tax purposes.

The Service's other concern as to whether all of the contracts qualify as insurable risks. 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 , a beneficial owner of the taxpayer.

Gross Receipts Test

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

Based the Service's analysis of the contracts, twelve of the fourteen 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. Amounts received by taxpayer for two of the fourteen direct written contracts were deemed to be premiums because only for those contracts included an insurance risk. During the taxable years under consideration, received amounts that the Service deemed to be direct written and reinsurance premiums as follows:

20XX

Contract	Premium
Excess Directors & Officers Liability	$ 0
Unauthorized Treatment Liability Policy	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

Contract	Premium
Excess Directors & Officers Liability	0
Unauthorized Treatment Liability Policy	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

Contract	Premium
Excess Directors & Officers Liability	0
Unauthorized Treatment Liability Policy	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%

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

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

During the tax years under consideration, the premium income received by taxpayer did not exceed 50% of its gross receipts. 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 November 8, 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 20XX-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 lack the requisite risk distribution. Therefore, the taxpayer does not qualify as an insurance company.

A Preliminary Report, Form 5701, *Notice of Proposed Adjustments*, was mailed to the taxpayer's CPA, , on November 8, 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 January 11, 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'd979 F.2d 1342 (9th Cir. 1992), where 30% unrelated risks was determined to be sufficient to meet the risk distribution requirement.

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

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

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

7. The taxpayer argues 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, based on an arithmetic counting of the number of insureds, 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 January 11, 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 second paragraph of the January 11, 20 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 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, the contracts written by are not contracts of insurance, annuity contracts or reinsurance contracts. Since more than half of business during the taxable years under consideration, does not involve issuing of insurance or annuity contracts or reinsuring of risks underwritten by insurance companies, is not an insurance company as described in section 816(a) 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 cites 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 2 on page 2 of the January 11, 20XX response:

> In its preliminary report, the Service merely , 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 0 percent of the total insurance business conducted.

Even if the CPA claimed that insurance exists under the rationale in the Harper case, where approximately 30% 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 3, paragraph 1, of the taxpayer's position, the CPA stated that the Service conducted no meaningful examination of risk distribution in its audit of . Rather, the Service

simply claims that the direct written contracts lack the requisite risk distribution. The nature of insurance is the number of underlying risk exposures present, not an artificial entity count or an artificial count of the number of policies written.

Government's Response:
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:
In paragraph 2, page 4, the CPA stated that in reaching its incorrect conclusion in the preliminary report, the Service appears to ignore Revenue Ruling 2001-31, in which the Service conceded that it would no longer assert the economic family theory due to its rejection by the courts.

Government's Response:
The current Service position is expressed in Ruling Revenue 2005-40, I.R.B. 2005-27 (June 17, 2005), which provides IRS issued guidance emphasizing that the requirement of risk distribution must be met. The ruling demonstrated that this risk distribution requirement cannot

be satisfied if the issuer of the contract enters into such a contract with only one policyholder. If the contract fails to constitute insurance, then the premiums paid are not deductible business expenses under Code Sec. 162 and the issuing company is not an insurance company for federal tax purposes. Rev. Rul. 2005-40 cited several court decisions that have recognized that risk distribution necessarily entails a pooling of premiums, so that a potential insured is not in significant part paying for its own risks. In this case, the large concentration of insurance risks in one insured does not constitute risk distribution because of the very high likelihood of the insured paying for any of its claims with its own premiums. Such an arrangement is not insurance but a form of self-insurance.

However, when the arrangements between the companies do constitute insurance for federal income tax purposes and assuming these arrangements represented more than 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:
In the last paragraph on page 5 of the January 11, 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:
20XX tax year comprised of only days. Thus, the taxpayer did not incur any claims against the direct written or reinsurance contracts. In its August 30, 20XX response to IDR #1, for the 20XX and 20XX tax years, the CPA indicated the taxpayer received one property and casualty claim of $0 in 20XX, and one claim of $0 in 20XX, against the Quota Share Reinsurance with . In both years, the claims incurred were actually less than the reinsurance premium received by the taxpayer from of $0 for 20XX and $0 for 20XX.

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.

There was no evidence that the taxpayer paid any losses under the Direct Written and Credit Coinsurance Reinsurance Agreements executed during the years under audit.
Under the direct written contracts, the taxpayer is the only party that assumed risks. Thus, if the Named Insureds filed claims, such claims would have been filed with and paid by the taxpayer only.

Taxpayer's Position:

In paragraph 3 on page 6, 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 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 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.

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

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.