Internal Revenue Service

Number: **200518010**
Release Date: 5/6/2005
Index Number: 831.00-00; 4371.01-00; 4372.02-00

Department of the Treasury
Washington, DC 20224

Third Party Communication: None
Date of Communication: Not Applicable

Person To Contact:
, ID No.
Telephone Number:

Refer Reply To:
CC:FIP:B04
PLR-125435-04

Date:
January 21, 2005

Legend

Parent	=
Sub	=
Number A	=
Number B	=
Number C	=
State D	=
Country E	=
Date 1	=
Fronting Company F	=
Fronting Company G	=
Company H	=
Date 2	=
Date 3	=
Date 4	=
Number I	=
Number J	=
Date 4	=
Company K	=

Dear

This responds to your letter of May 5, 2004, as supplemented by letters of August 2, 2004 and August 12, 2004, requesting certain rulings regarding the treatment of an arrangement to be entered into between Parent, entities affiliated with Parent, and Sub.

Parent is an organization described by § 501(c)(3) of the Internal Revenue Code ("Code") that is exempt from tax under § 501(a). Parent is the sole owner either directly or indirectly of several other organizations, some of which are described by § 501(c)(3) and some of which are not described by § 501(c)(3) or otherwise exempt from tax. (Collectively referred to as "Parent Affiliates".) Of the Parent Affiliates, Number A are corporations and Number B are limited liability companies disregarded as entities for federal income tax purposes. Some of the § 501(c)(3) Parent Affiliates in turn have ownership interests in condominium associations relating to medical office buildings ("Condo Associations").[1] Additionally, Parent has controlling ownership, either directly or indirectly, of several organizations that are not tax-exempt ("Parent-Controlled Entities"). Also involved in Parent's and Parent Affiliates' activities are Number C organizations described by § 501(c)(3) which Parent does not directly or indirectly control ("Non-Controlled Entities"). For purposes of this letter, "Parent Group" means the group comprised of Parent, Parent Affiliates, Condo Associations, Parent-Controlled Entities, and Non-Controlled Entities.

Parent Group operates in State D as a health care provider. As such, it faces various insurance risks: general liability, physician/hospital professional liability (including the malpractice risks of its employees), managed care liability, and pharmacy liability (collectively "Risks"). State D law caps the malpractice liability of a health care provider if the provider, among other things, maintains either liability insurance issued by an insurer admitted in State D or "self-insurance" in an amount specified by State D law. Parent Group determined that it could avail itself of the liability cap by obtaining liability insurance issued from an admitted insurer which the admitted insurer would then cede to a wholly owned subsidiary of Parent.

Parent incorporated Sub in Country E. The members of Sub's board of directors are executives of Parent or of a Parent Affiliate(s). The insurance regulatory authority of Country E issued Sub an insurance license. Parent capitalized Sub with the minimum amount required by Country X law to hold this license. Sub is not admitted to engage in the insurance business in State D.

On Date 1, Fronting Company F and Fronting Company G, both subsidiaries of Company H and insurers admitted in State D, issued Binder Letter covering Risks[2] for the period of Date 2[3] through Date 3. The coverage limits of Binder Letter varied with each of the Risks. Measured by exposure-weighting and considering the loss experience history, Parent accounts for 0.3% of the premium and risk, Parent Affiliates account for 96.3%, and the Parent-Controlled Entities, Condo Associations, and Non-Controlled Entities account for 3.4%. The Binder Letter was conditioned upon several things, all to be implemented in a manner approved by Fronting Company F and Fronting Company G:

[1] Parent Affiliates own controlling interest in all but one of these Condo Associations.
[2] Specifically, Binder Letter represented 34 policies, which can be categorized into five groups. Fronting Company F covered four of the groups and Fronting Company G writing the other.
[3] The managed care coverage was retroactive to Date 4.

1. that Sub agree to assume (without the right to cancel) all liabilities and adjustment expenses assumed by Fronting Company F and Fronting Company G under the Binder Letter;

2. that Sub post collateral and provide Fronting Company F and Fronting Company G a letter of credit. The amount of required collateral will be periodically reviewed and will be based on an actuarial estimate of the ultimate undiscounted losses covered by the Binder Letter; and,

3. that Parent guarantee Fronting Company F and Fronting Company G the payment of any and all obligations of Sub under the reinsurance agreement(s) between Sub and Fronting Company F and Fronting Company G.[4]

Additionally, Fronting Company F and Fronting Company G agreed to administer claims for a separate charge.

To implement condition #1, effective Date 2 Fronting Company F and Fronting Company G entered into Reinsurance Agreement, a facultative agreement with Sub whereby Fronting Company F and Fronting Company G ceded to Sub the Risks, including the expenses incurred to investigate and administer claims, covered by the Binder Letter. The reinsurance premium paid to Sub was 100% of the premium paid by Parent Group under the Binder Letter, less a ceding commission in the amount specified in Reinsurance Agreement. Reinsurance Agreement called for Sub to secure its ability to meet its obligations thereunder by funding and maintaining its the loss and unearned premium reserves as determined by Fronting Company F and Fronting Company G at a confidence level of Number I%. Reinsurance Agreement contemplates that Sub will fund and maintain a notional account which Fronting Company F and Fronting Company G can draw against to pay losses and loss expenses.

To implement condition #2 and to satisfy its obligation under Reinsurance Agreement to secure its ability to meet its obligations thereunder, contemporaneous with Reinsurance Agreement, Sub established Reinsurance Trust, naming Fronting Company F[5] beneficiary and an unrelated banking association trustee. Sub funded Reinsurance Trust with sufficient assets to fulfill its obligation under Reinsurance Agreement to secure its ability to perform thereunder. Reinsurance Trust required Sub to maintain sufficient assets in Reinsurance Trust to satisfy this obligation under Reinsurance Agreement. The assets are held in a trust account by the trustee, and only Fronting Company F, as beneficiary, can withdraw assets from Reinsurance Trust. The only

[4] Fronting Company F and Fronting Company G required this because of the concern that Sub's capital was inadequate to ensure its ability to perform under the Reinsurance Agreement.
[5] Fronting Company G is not a named beneficiary of Reinsurance Trust. It is represented that this may have been either an oversight or it may have been intended given that Fronting Company G assumed substantially less of Risks than Fronting Company F.

uses to which the Reinsurance Trust assets can be put are to satisfy Sub's obligations under Reinsurance Agreement or to return to Sub the excess over Number J% of the amount Reinsurance Agreement requires to be secured; Sub is obligated to pay the trustee's fee and other expenses associated with Reinsurance Trust out of other of its assets.

To implement condition #3, on Date 5, Parent executed Guarantee in favor of Fronting Company F.[6] Guarantee recites that in consideration for Binder Letter and Reinsurance Agreement, effective Date 2, Parent unconditionally guarantees Sub's performance of all obligations under Reinsurance Agreement and the payment in full of all amounts due from Sub under Reinsurance Agreement until Guarantee is terminated.

Sub's assets, other than the assets in Reinsurance Trust, are minimal, never significantly exceeding the minimum capital required by the insurance regulatory authority of Country E.

Sub has contracted with Company K to manage its day-to-day activities. The totality of Sub's activities will be those associated with Reinsurance Agreement.

The following rulings are requested:

1. The arrangements involving Sub with respect to Risks do not constitute insurance or reinsurance for federal tax purposes, and that Sub is not an insurance company as that term is used for purposes of § 831 of the Internal Revenue Code ("Code").

2. No portion of the amount paid in connection with the arrangements involving Sub with respect to risks is subject to the excise tax under § 4371.

Requested Ruling #1

Law

This requested ruling can be broken into two components: first, that the arrangements involving Sub with respect to Risks do not constitute "insurance" or "reinsurance" for federal tax purposes, and second, that Sub is not an "insurance company" as that term is used for purposes of § 831.

Neither the Code nor the regulations thereunder define the terms "insurance" or "insurance contract." The bedrock for evaluating whether an arrangement qualifies as

[6] It is represented that Guarantee was also to favor Fronting Company G. No document specifically referencing Fronting Company G was provided. However, the document provided states that it is in favor of "[Fronting Company F] and any of its parents, subsidiaries, or affiliates." Inasmuch as Fronting Company G is a sibling corporation to Fronting Company F, this document may have been operative to effect a guarantee in favor of Fronting Company G.

insurance is Helvering v. LeGierse, 312 U.S. 531, 539 (1941), in which the Court stated that "historically and commonly insurance involves risk - shifting and risk - distributing." Insurance has been described as "involv[ing] a contract, whereby, for adequate consideration, one party agrees to indemnify another against loss arising from certain specified contingencies or perils…[I]t is contractual security against possible anticipated loss." Epmeir v. United States, 199 F.2d 508, 509-10 (7th Cir. 1952). Cases analyzing "captive insurance" arrangements have distilled the concept of "insurance" for federal income tax purposes to three elements, applied consistently with principles of federal income taxation:[7] 1) involvement of an insurance risk; 2) shifting and distribution of that risk; and 3) insurance in its commonly accepted sense. See, e.g., AMERCO, Inc. v. Commissioner, 979 F.2d 162, 164-65 (9th Cir. 1992), aff'g 96 T.C. 18 (1991).

The risk transferred must be risk of economic loss. Allied Fidelity Corp. v. Commissioner, 572 F.2d 1190, 1193 (7th Cir. 1978). The risk must contemplate the fortuitous occurrence of a stated contingency, Commissioner v. Treganowan, 183 F.2d 288, 290-91 (2d Cir. 1950), and must not be merely an investment or business risk. LeGierse, 312 U.S. at 542; Rev. Rul. 89-96, 1989-2 C.B. 114.

Risk shifting occurs when a person facing the possibility of economic loss transfers some or all of the financial consequences of the potential loss to the insurer. See Rev. Rul. 92-93, 1992-C.B. 45 (where parent corporation purchased a group-term life insurance policy from its wholly owned insurance subsidiary, the arrangement was held to be not "self-insurance" because the economic risk of loss was not that of the parent), modified on other grounds, Rev. Rul. 2001-31, 2001-1 C.B. 1348. If the insured has shifted its risk to the insurer, then a loss by the insured does not affect the insured because the loss is offset by the insurance payment. See Clougherty Packing Co. v. Commissioner, 811 F.2d 1297, 1300 (9th Cir. 1987).

Risk distribution incorporates the statistical phenomenon known as the law of large numbers. Distributing risk allows the insurer to reduce the possibility that a single costly claim will exceed the amount taken in as a premium and set aside for the payment of such a claim. Insuring many independent risks in return for numerous premiums serves to distribute risk. By assuming numerous relatively small, independent risks that occur randomly over time, the insurer smoothes out losses to match more closely its receipt of premiums. See Clougherty Packing Co., 811 F.2d at 1300. Risk distribution necessarily entails a pooling of premiums, so a potential insured is not in significant part paying for its own risks. See Humana v. Commissioner, 881 F.2d 247, 257 (6th Cir. 1989).

The "commonly accepted sense" of insurance derives from all of the facts surrounding each case, with emphasis on comparing the implementation of the arrangement with that of known insurance. Court opinions identify several nonexclusive factors bearing

---

[7] These principles include respecting the separateness of corporate entities, the substance of the transaction(s), and the relationship between the parties. Sears, Roebuck and Co. v. Commissioner, 96 T.C. 61, 101-02 (1991), aff'd, 972 F.2d 858 (7th Cir, 1992).

on this, such as the treatment of an arrangement under the applicable state law, AMERCO, Inc., 96 T.C. at 41; the adequacy of the insurer's capitalization and utilization of premiums priced at arm's length, The Harper Group v. Commissioner, 96 T.C. 45, 55 (1991), aff'd 979 F.2d 1341 (9th Cir. 1992); separately maintained funds to pay claims, Ocean Drilling & Exploration Co. v. United States, 24 Cl. Ct. 714, 728 (1991), aff'd per curiam, 988 F.2d 1135 (Fed. Cir. 1993); and the language of the operative agreements and the method of resolving claims, Kidde Indus. Inc. v. Commissioner, 49 Fed. Cl. 42, 51-52 (1997).

Under § 301.7701-2(c)(2) of the Income Tax Regulations, a business entity that has a single owner and is not a corporation is disregarded as an entity separate from its owner. Under § 301.7701-2(a), the activities of a disregarded entity are treated in the same manner as a division of the owner. Rev. Rul. 2004-77, 2004-31 I.R.B. 119, holds that an entity with two members under local law, one of which is disregarded for federal tax purposes, must be classified either as an association taxable as a corporation or is disregarded as separate from its owner.

The risk of loss arising from the acts of employees for which an employer is liable under the doctrine of respondeat superior is considered to be that of the employer, not that of the individual employees. See Anesthesia Service Medical Group, Inc. v. Commissioner, 85 T.C. 1031, 1041-42 (1985), aff'd 825 F.2d 241, 242-43 (9th Cir. 1987); see also Humana v. Commissioner, 88 T.C. 197, 207-08 (1987), rev'd in part on other issue, 881 F2d 247 (6th Cir. 1989).

Rev. Rul. 2002-89, 2002-2 C.B. 984, holds that where a subsidiary provides coverage of its parent's insurance risk in the context of no parental guarantees of performance, and that coverage is less than 50% of the subsidiary's premiums and assumed risk, the coverage qualifies as insurance for federal income tax purposes. Where such coverage is 90% of the subsidiary's premiums and assumed risk, the coverage does not qualify as insurance for federal income tax purposes.

Rev. Rul. 2002-90, 2002-2 C.B. 985, concludes that an arrangement qualifies as insurance for federal income tax purposes where a subsidiary provides coverage of the insurance risks of 12 sibling corporations, each of which present a significant volume of independent, homogeneous risks and none of which account for less than 5% or more than 15% of the subsidiary's assumed risk with no parental (or other related party) guarantees of performance.

The presence of an explicit obligation by a subsidiary insurer's parent that has the effect of guaranteeing the subsidiary insurer's performance negates shifting of risk from the parent to the subsidiary, Carnation Co. v. Commissioner, 640 F.2d 1010 (9th Cir. 1981); Kidde Indus.; Rev. Rul. 2002-89; case law supports the position that where the insured subsidiaries join their parent in filing a consolidated return, a guarantee by the parent of the insuring subsidiary's performance will negate the shifting of risk from an insured subsidiary. Malone & Hyde, Inc. v. Commissioner, 62 F.3d 835, 842-43 (6th Cir. 1995);

Gulf Oil Corp. v. Commissioner, 914 F.2d 396, 412 (3rd Cir. 1990); Humana, 881 F.2d at 253-54. Rev. Rul. 2002-90 (noting in the facts the absence of a parental or other related party guarantee).

For taxable years beginning before December 31, 2003, an insurance company (other than a life insurance company) for federal tax purposes is a company whose primary and predominant business activity during the year was the issuing of insurance or annuity contracts or the reinsuring of risks underwritten by insurance companies. Section 1.801-3(a)(1) of the Income Tax Regulations. For taxable years beginning after December 31, 2003, an insurance company (other than a life insurance company) for federal tax purposes is a Company more than half 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)(For effective date, see Pension Funding Equity Act of 2004, Pub. L. No. 108-218, § 206(e)(1), 118 Stat. 596, 611 (2004)).

Analysis

Risks covered by Binder Letter are insurance risks. Risks are either inherently sourced to the business entities that comprise Parent Group (e.g., general liability) or deemed sourced to the business entities that comprise Parent Group (e.g., professional liability, see Anesthesia Service). Accordingly, for purposes of evaluating whether the arrangements involving Sub constitute insurance or reinsurance for federal tax purposes, Risks are considered those of the business entities comprising Parent Group.

The Number B of Parent Affiliates which are disregarded as entities separate from Parent for federal income tax purposes are instead treated as divisions of Parent; thus the Risks allocable to these Parent Affiliates are deemed to be those of Parent.

The structure of Parent Group demonstrates Risks are covered in three forms of corporate relationship: a parent-subsidiary arrangement (Risks allocable to Parent), a sibling (brother-sister) arrangement (Risks allocable to Parent Affiliates, Condo Associations, Parent-Controlled Entities), and an arrangement between unrelated corporations (Risks allocable to Non-Controlled Entities[8]).

With respect to the parent-subsidiary arrangement, Guarantee negates the shifting of risk from Parent to Sub. The parent-subsidiary arrangement does not qualify as insurance (or reinsurance) for federal income tax purposes.

Similarly, with respect to the sibling arrangement, the arrangement fails to qualify as insurance (or reinsurance) for federal income tax purposes because Guarantee negates the shifting of risk.

[8] Plus the one Condo Association of which Parent Affiliates do not own controlling interest.

With respect to the arrangement between unrelated corporations, though the unrelated corporations can be said to have shifted their risk to Sub, the small number of unrelated corporations involved precludes finding risk distribution. Accordingly, the arrangement between unrelated corporations does not qualify as insurance (or reinsurance) for federal income tax purposes.

Based on the facts represented by Taxpayer, we conclude that the arrangements involving Sub with respect to Risks do not constitute insurance or reinsurance for federal income tax purposes.

Taxpayer represents that Sub does not engage in a business activity other than Reinsurance Agreement, which we conclude does not qualify as insurance for federal income tax purposes. Therefore, based on Taxpayer's representations, we conclude that Sub does not qualify as an insurance company for federal income tax purposes.

Requested Ruling #2

Law

Section 4371 imposes a tax on each policy of insurance, indemnity bond, annuity contract, or policy of reinsurance issued by a foreign insurer or reinsurer. Section 4372(a) defines "foreign insurer or reinsurer" as an insurer or reinsurer who is a nonresident alien individual, or a foreign partnership, or a foreign corporation.

Section 4371(1) imposes the tax at a rate of four cents on each dollar, or fractional part thereof, of the premium paid on a policy of casualty insurance or an indemnity bond (defined by §§ 4372(b) and (c), respectively), if issued to or for, or in the name of, an insured as defined by § 4372(d).
Section 4372(d) defines the term "insured" to mean "a domestic corporation or partnership, or an individual resident of the United States, against, or with respect to, hazards, risks, losses, or liabilities wholly or partly within the United States" or "a foreign corporation, foreign partnership, or nonresident individual, engaged in a trade or business within the United States, against, or with respect to, hazards, risks, losses, or liabilities within the United States."

Section 4371(3) imposes the tax at a rate of one cent on each dollar, or fractional part thereof, of the premium paid on the policy of reinsurance covering any of the contracts taxable under § 4371(1).

Section 4372(f) defines a "policy of reinsurance" to mean "any policy or other instrument by whatever name called whereby a contract of reinsurance is made, continued, or renewed against, or with respect to, any of the hazards, risks, losses, or liabilities covered by contracts taxable under" § 4371(1).

Analysis

We conclude that the arrangements involving Sub with respect to Risks do not constitute insurance or reinsurance for federal income tax purposes. Accordingly, § 4371 does not apply to these arrangements.

Except as expressly provided herein, no opinion is expressed or implied concerning the tax consequences of any aspect of any transaction or item discussed or referenced in this letter.

This ruling is directed only to the taxpayer requesting it. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

In accordance with the Power of Attorney on file with this office, a copy of this letter is being sent to your authorized representative.

A copy of this letter must be attached to any income tax return to which it is relevant.

The rulings contained in this letter are based upon information and representations submitted by the taxpayer and accompanied by a penalty of perjury statement executed by an appropriate party. While this office has not verified any of the material submitted in support of the request for rulings, it is subject to verification on examination.

Sincerely,

/s/

Donald J. Drees, Jr.
Acting Chief, Branch 4
Office of Associate Chief Counsel
(Financial Institutions and Products)