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Person To Contact:
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Legend

Taxpayer =

Industry =
State =
Unit =
Operator =
Statute 1 =

Statute 2 =

Statute 3 =
Statute 4 =
Fund =
Number A =

Dear

This responds to your April 4, 2005 request for a ruling that you are taxable as an insurance company other than a life insurance company pursuant to § 831 of the Internal Revenue Code.

FACTS

Industry operates within State in the following manner: a customer contracts with Unit to procure services. Unit then refers the contract to an Operator. Operator performs the specified services for the customer. Operator collects from customer the fee for the specified services and Operator remits (less its allocable portion) the payment to Unit. The Operators are classified as "independent contractors," not as

employees of Unit. The Operators face the possibility of injury while performing the specified services. However, because the Operators are not employees they are not covered by workers' compensation laws.

In order to provide workers' compensation benefits for Operators, State revised its workers' compensation laws and created Taxpayer as a not-for-profit corporation to administer and pay workers' compensation benefits to Operators. Each Unit doing business as such within State is required to be a member of Taxpayer; though as such each Unit can participate in governing Taxpayer, no "profit" earned by Taxpayer can be distributed to, or inure to the benefit of, any Unit. Statute 1; Statute 2. Taxpayer determines the amount needed to fund its activities. This amount is converted to a surcharge added to the fee for specified services. Unit collects the surcharge and remits it to Taxpayer. For purposes of workers' compensation only, Operators are deemed employees of Taxpayer while performing the specified services. Statute 3; Statute 4. As allowed by law, Taxpayer satisfies its obligation to administer and pay workers' compensation benefits to Operators through a policy issued by Fund. Several hundred Units are a member of Taxpayer and more than that number of individual Operators are covered by Taxpayer.

Besides the surcharges remitted by Units, Taxpayer receives de minimis revenue (Number A% of its total) from its investments.

REQUESTED RULING

Taxpayer requests a ruling that it is taxable as an insurance company other than a life insurance company under § 831 of the Internal Revenue Code.

LAW AND ANALYSIS

Qualification as an insurance company must be satisfied annually. Section 1.801-3(a)(1) of the Income Tax Regulations; Indus. Life Ins. Co. v. United States, 344 F.Supp. 870, 877 (D.S.C. 1972) aff'd per curiam 481 F.2d 609 (4th Cir. 1973). For taxable years beginning after December 31, 2003, the definition of an insurance company other than a life insurance company is found in §831(c), which defines an insurance company by reference to §816(a). Section 816(a) defines an insurance company as any 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.

Neither the Code nor the regulations define the terms insurance or reinsurance. The United States Supreme Court, however, has explained that for an arrangement to constitute insurance for Federal income tax purposes, both risk shifting and risk distribution must be present. Helvering v. LeGierse, 312 U.S. 531 (1941). The risk

transferred must be risk of economic loss. Allied Fidelity Corp. v. Commissioner, 572 F.2d 1190, 1193 (7th Cir.), cert. denied, 439 U.S. 835 (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 if a person facing the possibility of an economic loss resulting from the occurrence of an insurance risk transfers some or all of the financial consequences of the potential loss to the insurer. The effect of such a transfer is that a loss by the insured will not affect the insured because the loss is offset by the insurance payment. Risk distribution incorporates the law of large numbers to allow the insurer to reduce the possibility that a single costly claim will exceed the amount available to the insurer for the payment of such a claim. 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). See also Kidde Indus. Inc. v. United States, 40 Fed. Cl. 42, 58 (1997).

While a taxpayer's name, charter powers, and state regulation help to indicate the activities in which it may properly engage, whether the taxpayer qualifies as an insurance company for tax purposes depends on its actual activities during the year. Inter-American Life Ins. Co. v. Commissioner, 56 T.C. 497, 506-08 (1971), aff'd per curiam, 469 F.2d 697 (9th Cir. 1972) (taxpayer whose predominant source of income was from investments did not qualify as an insurance company); see also Bowers v. Lawyers Mortgage Co., 285 U.S. 182, 188 (1932). To qualify as an insurance company, a taxpayer "must use its capital and efforts primarily in earning income from the issuance of contracts of insurance." Indus. Life Ins. Co., at 877. All of the relevant facts will be considered, including but not limited to, the size and activities of any staff, whether the company engages in other trades or businesses, and its sources of income. See generally United States v. Home Title Ins. Co., 285 U.S. 191, 195 (1932) (where insurance and charges incident thereto were more than 75% of company's income, "[u]ndeniably insurance [was] its principal business."); Lawyers Mortgage Co. at 188-90; Indus. Life Ins. Co., at 875-77; Cardinal Life Ins. Co. v. United States, 300 F. Supp. 387, 391-92 (N.D. Tex. 1969), rev'd on other grounds, 425 F. 2d 1328 (5th Cir. 1970); Serv. Life Ins. Co. v. United States, 189 F. Supp. 282, 285-86 (D. Neb. 1960), aff'd on other grounds, 293 F.2d 72 (8th Cir. 1961); Inter-American Life Ins. Co., at 506-08 ; Nat'l. Capital Ins. Co. of the Dist. of Columbia v. Commissioner, 28 B.T.A. 1079, 1085-86 (1933). However, a company engaged solely in reinsurance may have a very sparse operation. See Alinco Life Ins. Co. v. United States, 178 Ct. Cl. 813, 837-38 (1967)(that reinsurance company had extremely simple operation with very little general operating expense did not preclude conclusion that it was a life insurance company under § 801).

The business of an insurance company necessarily includes substantial investment activities. Both life and nonlife insurance companies routinely invest their capital and the amounts they receive as premiums. The investment earnings are then used to pay claims, support writing more business or to fund distributions to the company's owners. The presence of investment earnings does not, in itself, suggest that an entity does not qualify as an insurance company.

"Workers' compensation" is a statutorily created mechanism to effect a practicable and consistent remedial regime for on-the-job injuries. Prior to the enactment of workers' compensation, traditional tort law applied to injuries suffered by an employee in the course of performing a job. Workers' compensation is in effect a "bargain" between the employee and the employer whereby the employer is deemed strictly liable for workplace injuries and the employee is entitled to a certain (though potentially smaller) amount as compensation. See 82 Am. Jur. 2d *Workers' Compensation* § 1 (2003); Jack B. Hood, et al., WORKERS' COMPENSATION AND EMPLOYEE PROTECTION LAWS (2005). Independent contractors generally are not covered by workers' compensation provisions. Hood, supra, at 49.

The underlying predicate for workers' compensation is the employer's potential liability – an economic risk of loss - to the employee. This potential liability is viewed as the risk of the employer for purposes of insurance qualification. See Rev. Rul. 83-172, 1983-2 C.B. 107; Kidde Indus., Inc. v. United States, 40 Fed. Cl. 42 (1997).

Here, the underlying predicate is not present. Operators are classified as independent contractors of Units. But for the revision to State's workers' compensation laws, Operators would have no recourse against Units or Taxpayer to remedy injuries suffered while performing the specified duties.[1] Accordingly, the risk of loss involved here is the Operators', not Units' or Taxpayer's. This risk of loss is an insurance risk. For the consideration of the surcharge, this risk is shifted from Operators to Taxpayer[2] and distributed across the many similarly situated Operators. This arrangement constitutes insurance for federal income tax purposes and Taxpayer will be an insurance company within the meaning of § 831(c) for each taxable year that this arrangement is more than half of its business.

CAVEATS

Except as expressly provided herein, no opinion is expressed concerning the tax consequences of any aspect of any transaction or item discussed or referenced in this letter. No ruling has been requested, and no opinion is expressed, concerning the

[1] While Operators may have had some recourse against Units, the statute deems Operators to be employees of Taxpayer, not Units.
[2] Units serve as a vehicle to collect the surcharge.

treatment by Operators and Units of the surcharge paid to Taxpayer and the treatment by Operators of amounts received from Taxpayer.

Sincerely yours,

DONALD J. DREES
Senior Technician Reviewer, Branch 4
Office of Associate
Chief Counsel
(Financial Institutions & Products)