NO PROTEST RECEIVED
Release copies to District [redacted]

Date [redacted]

Surname [redacted]

[redacted]

Employer Identification Number: [redacted]

Dear Taxpayer:

This refers to your application for recognition of exemption from federal income tax as an organization described in section 501(c)(15) of the Internal Revenue Code

The information furnished shows that you were incorporated under the laws of [redacted] on [redacted]. You are seeking exemption for [redacted] and subsequent years. The financial data reflects that you operate on a fiscal year basis, ended on [redacted].

The information furnished shows that [redacted] (hereafter [redacted]) is your sole shareholder. The information reflects that in addition to the $[redacted] paid for your stock, [redacted] contributed an additional $[redacted] to you.

[redacted] is a medical services company that provides by contract physicians to cover emergency room services in various hospitals in [redacted]. [redacted] has [redacted] physicians as employees and another [redacted] physicians are under contract as independent contractors. [redacted] is owned by [redacted] physicians that are shareholder employees, with each shareholder owning [redacted] shares of [redacted]. [redacted] has recently been acquired by [redacted], [redacted], which does not include any other insurance company.

The information furnished shows that in [redacted] you wrote one medical malpractice insurance policy. You issued this medical malpractice insurance policy to [redacted]. This was a claims made policy in the amount of $[redacted] per each claim with $[redacted] of total policy aggregate coverage. The initial policy period was from [redacted] to [redacted] with a retroactive date of [redacted]. The yearly premium for the coverage provided in the policy was $[redacted]. A total of [redacted] physicians were covered by your initial policy.

The information furnished shows that during this same period of time [redacted] had an additional medical malpractice insurance coverage with [redacted], which is a [redacted] insurance

[redacted]

company. This policy noted that the underlying "insurance" was provided by you. The [redacted] coverage was for [redacted] each claim and aggregate coverage was for $[redacted]. This policy showed the amount of the coverage provided by you so that the total limit of coverage provided by both policies was $[redacted] each claim and $[redacted] in the aggregate. The premium for the [redacted] policy for the period from [redacted] to [redacted], was $[redacted]. Unlike your policy that listed [redacted] physicians on the attached schedule, the [redacted] policy listed eight locations which were either hospitals or health centers as covered locations. Under the [redacted] policy, [redacted] was suppose to post a $[redacted] letter of credit as collateral for its limits of insurance.

The information furnished indicates that [redacted] would look to [redacted] for satisfaction of their "self-insured retention." However, because [redacted] obtained coverage for their selfinsured retention from you, it appears that [redacted] would look to you since the $[redacted] letter of credit was collateral for the $[redacted] self-insured retention.

The financial statement concerning your period of operation from [redacted] to [redacted], showed that you had total assets of $[redacted] and total liabilities of $[redacted] with total shareholder equity of $[redacted]. The balance of your loss and loss adjustment expense reserves as of [redacted] was $[redacted]. The audit report dated [redacted] that was prepared by [redacted] your CPA firm, contained the following note.

> "As described in Note B to the financial statements, [[redacted]] management believes that the statement of reserves losses incurred but not reported is reasonable in the circumstances; however, there is an absence of sufficient loss experience on which to evaluate whether [[redacted]] actual incurred losses and loss adjustment expenses will conform to the assumptions used in determination of liability, and were not able to satisfy ourselves as to the adequacy of the loss reserves by other auditing procedures."

Section 501(c)(15) provides that "[i]nsurance companies or associations other than life" are exempt from taxation under § 501(a) if "net written premiums (or, if greater, direct written premiums) for the taxable year do not exceed $350,000." § 501(c)(15)(A).

Section 843 of the Code provides that the annual accounting period for each insurance company subject to a tax imposed this subchapter shall be the calendar year.

[redacted]

Section 1504 (b) of the Code indicates that a "corporation exempt from tax under section 501" is not an "includible corporation" for the purpose of including it as part of "affiliated group" for the purpose of filing a consolidated return.

Insurance companies other than life insurance companies are taxed under section 831. Section 1.831-3(a) of the Income Tax Regulations states that for purposes of sections 831 and 832, the term "insurance companies" means only those companies which qualify as insurance companies under former section 1.801-1(b) of the regulations (now section 1.801-3(a)(1) of the regulations).

Section 1.801-3(a)(1) of the regulations states that the term "insurance company" means a company whose primary and predominant business activity is the issuance of insurance contracts or the reinsuring of risks underwritten by insurance companies.

The term "insurance company" has the same meaning under section 501(c)(15) as under Subchapter L of the Code (relating to taxation of insurance companies). See II Conf. Rep. No. 99-841, 99th Cong. 2d Sess. 370-71, reprinted in 1986-3 (Vol.4) C.B. 370-71; see also Rev. Rul. 74-196, 1974-1 C.B. 140, for a similar conclusion under prior law.

The principal test for what constitutes "insurance" for federal income tax purposes is set out in Helvering v. Le Gierse, 312 U.S. 531 (1941). In that case, the Supreme Court stated that "[h]istorically and commonly insurance involves risk-shifting and risk-distributing." Id. at 539. Further, the Court stated that this risk must be an "insurance risk" as opposed to an "investment risk." Id. at 542. In Allied Fidelity Corp. v. Commissioner, 66 T.C. 1068, 1074 (1976), aff'd, 572 F.2d 1190 (7th Cir. 1978), the Tax Court wrote that this risk is a risk of "a direct or indirect economic loss arising from a defined contingency," so that an "essential feature of insurance is the assumption of another's risk of economic loss."

Neither the Code nor the regulations thereunder define the term "insurance contract." However, case law has defined "insurance contract" as "a contract whereby, for an adequate consideration, one party under takes to indemnify another against the risk of loss from certain specified contingencies or peril... [It] is a contractual security against possible anticipated loss." Epmeier v. U.S., 199 F.2d 508, 509-10 (7th Cir. 1952). See, also, SEC v. Variable Annuity Life Ins. Co., 359 U.S. 65, 71 (1959): Group Life & Health Ins. Co. v. Royal Drug Co., 440 U.S.

[redacted]

[redacted]

205, 211 (1979); Union Labor Life Ins. Co. v. Pireno, 458 U.S. 119, 127 (1982); 1 Couch on Insurance 2d (Rev. ed) S S 1:2, 1:3 (1984).

In evaluating whether an arrangement between affiliated companies constituted insurance, the Tax Court has stated that three conditions must be satisfied for insurance to exist: (1) an insurance risk (as opposed to an investment or speculative risk) must be present; (2) the arrangement must shift and distribute risk; and (3) the arrangement must be insurance in its commonly accepted sense. AMERCO v. Commissioner, 96 T.C. 18, 38 (1991), aff'd 979 F.2d 162 (9th Cir.1992); Sears, Robeck and Co. v. Commissioner, 96 T.C. 61, 100-102 (1991), aff'd 972 F.2d 858 (7th Cir. 1992) The Harser group v. Commissioner 96 T.C. 45, 58 (1991), aff'd 979 F.2d 1341 (9th Cir. 1992).

In Anesthesia Service Medical Group v. Commissioner, 85 T.C. 1031 (1985), aff'd 825 F.2d 241 (9th Cir. 1987), the Tax Court considered whether a trust created by a medical group to provide medical malpractice coverage to the medical group's physician/employees constituted an insurance company for federal income tax purposes. The court held that the trust did not constitute an insurance company because the medical group was liable for the negligent acts of its physician/employees under the doctrine of respondeat superior and, therefore the risk of loss was not shifted from the medical group to the trust. The Tax Court indicated that there can exist no risk distribution without risk shifting. The Appeals Court affirmed the decision for the reasons stated by the Tax Court. Regarding the taxpayer's argument that the trust provides payments not of claims against it but rather of claims against its employees, the appeals Court stated that this is a distinction without significance also citing the doctrine of respondeat superior under which the taxpayer is liable for the tortious acts of its employees within the scope of their employment. By distributing trust funds for payment of claims against its employees, taxpayer is able to satisfy malpractice claims from which it also would be liable. Thus, the taxpayer's payment to the trust are not a business expense under section 162.

Rev. Rul. 88-72, 1988-2 C.B. 31, as clarified by Rev. Rul. 89-61, 1989-1 C.B. 75, explains the difference between risk shifting and risk distribution. Risk shifting occurs where a risk is shifted away from a corporate parent and its subsidiaries. Risk distribution occurs when an insurance company accepts a large number of independent risks, and thereby takes advantage of a statistical phenomenon known as the "law of large numbers." Although the potential loss exposure increases, the average loss incurred becomes increasingly predictable.

You neither issue annuity contracts nor reinsure risks underwritten by insurance companies. Thus, whether you qualify as an insurance company depends upon whether your predominant activity is the issuing of insurance contracts.

Risk shifting occurs when a person facing the possibility of an economic loss transfers some or all of the financial consequences of the loss to the insurer. Rev. Rul. 88-72, 1988-2 C.B. 31, clarified by Rev. Rul. 89-61, 1989-1 C.B. 75.

Risk distribution refers to the operation of the statistical phenomenon known as the "law of large numbers," when additional statistically independent risk exposure units are insured, an insurance company's potential total loss increases, as does the uncertainty regarding the amount of that loss. As the uncertainty regarding the company's total loss increases, however, there is an increase in the predictability of the insurance company's average loss. Due to this increase in the predictability of average loss, there is a downward trend in the amount of capital that the company needs per risk unit to remain at a given level of solvency. See Rev. Rul. 89-61.

The information furnished show that you have written one medical malpractice insurance policy covering [redacted] and [redacted]'s medical professionals. This policy is an excess medical malpractice insurance policy. Because this policy covers both [redacted] and [redacted]'s medical professionals; and because [redacted] wholly owns you, we conclude that your arrangement with [redacted] is a self-insurance arrangement.

Based on the facts submitted, we are unable to distinguish your operations from those of the organization that was the subject of Anesthesia Medical Service Group, supra, regarding the question of whether you should be treated as an insurance company. As in Anesthesia Medical Service Group, supra, [redacted] is your sole owner, and you were established by [redacted] to provide it with medical malpractice coverage. The risks covered in the contract issued by you to [redacted] are [redacted]'s risks. Therefore, the risk of loss was not shifted from [redacted] to you. If there is no risk shifting, there is no risk distribution. Therefore, since you are not an insurance company for purpose of subchapter L of the Code, you are not an insurance company for purpose of section 501(c)(15).

Consequently, since you are not an "insurance company" within the meaning of section 501(c)(15) of the Code, you do not qualify for recognition of exemption from federal income tax under section 501(c)(15).

Furthermore, the information furnished shows that you operate on a fiscal year basis ended [redacted]. Pursuant to section 834 of the Code, an insurance company's annual accounting period must be the calendar year unless it is included in a consolidated return with its parent, which operates on a fiscal year basis. However, pursuant to section 1504(b) of the Code, an organization, that is exempt from tax under section 501 of the Code, can not be included in a consolidated return with another entity, except an entity described in section 501 of the Code.

You have the right to protest this ruling if you believe it is incorrect. To protest, you should submit a statement of your views, with a full explanation of your reasoning. This statement, signed by one of your officers, must be submitted within 30 days of the date of this letter. You also have a right to a conference in this office after your statement is submitted. You must request the conference, if you want one, when you file your protest statement. If you are to be represented by someone who is not one of your officers, that person will need to file a proper power of attorney and otherwise qualify under our Conference and Practices Requirements.

You will expedite our receipt of your protest statement by using the following address on the envelope:

[redacted]

If we do not hear from you within 30 days, this ruling will become final and copies will be forwarded to your key District Director in [redacted]. Thereafter, any question about your federal income status should be addressed to that office.

Sincerely yours,

[redacted]

Chief, Exempt Organizations
[redacted]

cc: [redacted]
Attn: EO Group
cc: [redacted]