Internal Revenue Service
Appeals Office

Release Number: **201613016**
Release Date: 3/25/2016
Date: December 28, 2015

ORG
ADDRESS

Department of the Treasury

Employer Identification Number:

Person to Contact:

Employee ID Number:
Tel:
Fax:

Tax Period(s) Ended:
December 31, 20XX
December 31, 20XX
December 31, 20XX

Certified Mail

UIL: 0501.15-00

Dear

This is a final determination that you do not qualify for exemption from Federal income tax under Internal Revenue Code (the "Code") section 501(a) as an organization described in Code section 501(c)(15) for the tax periods listed above.

The final adverse determination of your exempt status was made for the following reason(s):

Taxpayer is not an insurance company exempt from tax pursuant to Code § 501(c)(15) as of 20XX, 20XX and 20XX.

You are required to file Federal income tax returns on Forms 1120 for the tax periods stated in the heading of this letter and for all tax years thereafter. File your return with the appropriate Internal Revenue Service Center per the instructions of the return. For further instructions, forms, and information please visit www.irs.gov.

Please show your employer identification number on all returns you file and in all correspondence with Internal Revenue Service.

We will make this letter and the proposed adverse determination letter available for public inspection under Code section 6110 after deleting certain identifying information. We have provided to you, in a separate mailing, Notice 437, *Notice of Intention to Disclose.* Please review the Notice 437 and the documents attached that show our proposed deletions. If you disagree with our proposed deletions, follow the instructions in Notice 437.

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 556

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE

TAX EXEMPT AND
GOVERNMENT ENTITIES

Date: June 19, 2014

Taxpayer Identification Number:

ORG

ADDRESS

Form:
990-EZ /990
Tax Period(s) Ended:
12/31/20XX; 12/31/20XX; 12/31/20XX
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,

Acting 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 ORG	Tax Identification Number	Year/Period ended 12/31/20XX 12/31/20XX 12/31/20XX

ISSUES:

1. Whether the contracts executed by ORG constitute contracts of insurance?
2. Whether the arrangement entered into by ORG involves the requisite element of risk distribution?
3. Whether more than half of the business of ORG 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?
4. If ORG 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 the IRC 953(d) election valid if the taxpayer is not an insurance company, and the election was never approved by the Service?

FACTS:

ORG ("Taxpayer") was formed and incorporated in Country, Territory on November 22, 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 Parent CO, a State limited liability company, located at Address, City, State Zip code. Parent CO, as the sole shareholder, purchased 0 shares of the taxpayer's stock for $0, on November 22, 20XX. Parent CO is owned by Partner-1 (0%), Partner-2, (0%) and Partner-3 (0%). Partner-1 and Partner-2 are father and son. Both Partners are U.S. citizens, who reside in City, State.

The TEGE examining agent obtained a copy of taxpayer's Form 1024 application administrative file from Rulings and Agreements in Washington D. C., on February 13, 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 Partner-1 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, 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, Partner-1. and Partner-2. Partner-1 serves as Chief Executive Officer (CEO), President, Treasurer, and Assistant Secretary of ORG Partner-2 serves as Vice President, Secretary, and Assistant Treasurer of the taxpayer.

Partner-1 is also the majority Partner-1 of CO-1, the CO-2; CO-3, CO-4; and CO-5. Partner-2 and Indv-1 also own minority interest in some of these business interests, called "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. ORG 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, Partner-1, President, signed an IRC 953(d) election statement on February 26, 20XX. It appears that the election statement was filed with the IRS City, State office on the same day.

On June 24, 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 short tax year of the taxpayer. Taxpayer did not file any federal income tax or information returns prior to filing the Form 1024 application. Partner-1, President, signed the application on June 10, 20XX. A Form 2848, Power of Attorney, accompanied the application authorizing Attorney-1, Attorney, Attorney-2, Attorney, and Attorney-3, Attorney, to represent the taxpayer during the application process. The attorneys worked for Law Firm, a law firm in City, State.

The application revealed that the taxpayer hired CO-6, to serve as its resident insurance manager in Country, Territory. The taxpayer agreed to pay compensation of less than $0 annually.

On September 1, 20XX, the Form 1024 application was referred to Rulings and Agreements in Washington, D.C., for consideration and ruling. Apparently, before the application was assigned to a Tax Law Specialist for review, the organization's representative, faxed a letter, on September 20, 20XX, to Rulings and Agreements and to , Director, Exempt Organizations Rulings & Agreements, requesting that the Form 1024 application be withdrawn from consideration and ruling by Rulings & Agreements. The letter was signed by Partner-1, President, on September 17, 20XX.

On December 23, 20XX, Rulings & Agreements mailed a letter to ORG, at Address, City, State Zip code, acknowledging receipt of the applicant's September 17, 20XX letter, and informing the applicant that no further action would be taken on the application and the matter was considered closed. The applicant was also advised that the User Fee was not refundable, and if it sought another determination letter in the future, a new User Fee payment would be required. The letter issued by Rulings & Agreements was signed by , for , Director, Exempt Organizations Rulings & Agreements.

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 February 17, 20XX, the TE/GE examining agent requested the effective date of the IRC 953(d) election from the IRS City, State office. Later that day, the IRS City, State office informed the examining agent that the Service does not have record that the IRC 953(d) election was approved.

The taxpayer's initial tax year consisted of the period, November 22, 20XX (the date of incorporation), through December 31, 20XX. The taxpayer filed Form 990-EZ for its initial short tax year. Taxpayer also filed Form 990 returns for the 20XX, and 20XX tax years.

The Financial Services Commission, Country, issued a Class 'B: General Insurance License to the taxpayer effective December 8, 20XX. The taxpayer conducted limited business during the period of December 8, 20XX, through December 31, 20XX. During the years under audit, the taxpayer operated primarily to provide property and casualty "insurance" coverage to CO-1, and Affiliated Businesses, which are primarily owned and controlled by Partner-1, and Partner-2, officers and beneficial Partner-1s of ORG

In 20XX, the taxpayer wrote twelve (12) direct-written contracts to CO-1 and Affiliated Businesses, as follows: 1. Excess Directors and Officers; 2. Employment Practices Liability; 3. Special Risk – Expense Reimbursement; 4. Legal Expense Reimbursement; 5. Special Risk – Cargo/Transit; 6. Special Risk – Loss of Service; 7. Special Risk – Loss of Major Business to Business Relationship.; 8. Excess Pollution Liability; 9. Special Risk - Product Recall; 10. Special Risk - Punitive Wrap; 11. Special Risk - Regulatory Changes; and 12. Special Risk - Tax Liability.

Under the terms of each policy, ORG was listed as the Lead Insurer and assumed 81.5% of the risk. CO-8, as Stop Loss Insurer, assumed the remaining 18.5% of the risk.

Each policy listed CO-1, the CO-2; CO-3, and CO-4; located at Address, City, State Zip code, as the Named Insureds.

Supplemental information submitted by taxpayer with the Form 1024 application revealed that each of the Named Insureds is primarily owned as follows:

	Partner-1	Partner-2	Indv-1
CO-1[1]	0%	0%	0%
CO-2	0%	0.0	0.0
CO-3	0%	0%	0.0

CO-4 is wholly owned (0%) by the Partner-2 Irrevocable Management Trust.

Each of the direct written contracts issued by the taxpayer during the 20XX tax year is described below:

1. Directors & Officers Liability

CO-2 has an uninsured directors and officers liability exposure, which could be a serious issue if, for example, allegations of misrepresentation were made against the CO-2 for a marketing effort.

The Company has over 0 employees. In today's litigious environment, it is likely for a company the size of CO-2 with a predominantly blue collar workforce to have several uninsured employment practices liability incidents, and it is probable that one or more of those incidents will result in EEOC investigations and/or loss.

2. Employment Practices Liability

Covers claims made by any of CO-2's 0+ employees alleging employment related risk exposures. The Company is potentially at risk for employment practices liability for discrimination, harassment, wrongful termination, or other similar inappropriate act. In some jurisdictions, actions related to civil rights allegations can come from third parties such as customers and independent contractors.

[1] Other owners are: CO-4 (0%); the CO-7 (0%); Trust-1 (0%); and the CO-2 (0%).

3. Expense Reimbursement

Any claims that arise, including claims associated with products liability or product recall, would cause the Company to have costs related to managing a public relations campaign to restore its customers' faith.

Uninsured legal expenses and litigation expense associated with disputes between the insured and its insurers related to claims also represent a risk to the Company. Potentially catastrophic claims are often denied by conventional insurers on financial grounds. A separate policy through the captive for litigation expense would be advisable.

4. Legal Expense Reimbursement

Covers all litigation expenses incurred by the insured resulting for insured's 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.

5, Special Risk CargoTransit

Provides coverage for transit losses for all common carrier shipments. Over $0 million will be shipped in 20XX without separate cargo coverage. The trucking companies have low limitations on the loss or damage of property, which is generally inadequate. A separate cargo policy through the captive insurer is recommended to prevent financial loss from transportation risks.

6. Loss of Services

With CO-2 structured as a limited partnership, there are several partners whose services are critical to the operations of the business, including Partner-1, Partner-2, Indv-1, and Partner-4. The Company is also has a loss of services exposure associated with its three most productive salespersons; Emp-1, Emp-2 and Emp-3. Should the Company lose the services of any one of these key people, it would not only suffer a business interruption loss while finding a suitable replacement, but it may also incur significant legal expenses enforcing non-compete and confidentiality agreements.

7. Loss of Major Business to Business Relationships

CO-2 is indemnified from any Business Interruption loss of up to twelve (12) months suffered as a result of the loss of reduction of services of a Major Business-to-Business Relationship(s) as specified as any business relationship that contributes 0% or more to revenue.

8. Excess Pollution Liability

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,

clear air, clear 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.

9. Special Risk – Product Recall

Reimburses CO-2 for recall costs associated with any of its 0 inventory items. If a product is determined to be out of specification, or defective, CO-2 will need to research the extent of the defect within the product line and recall those products that are affected. Given the long supply chain and with several base materials originating outside the United States, the risk of recall in the supply chain is significant.

10. Special Risk – Punitive Wrap Liability

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

11. Special Risk - Regulatory Changes

CO-2 is at risk of external factors such as regulatory changes in locksmith licensing and local codes. The Company could incur a significant loss of income if significant changes in locksmith licensing changes interrupt its marketing strategy or if changes in local codes force the company to secure alternative inventory.

12. Special Risk - Tax Liability

The Company is at risk if it were to suffer an adverse decision from an unexpected tax audit with regard to its organizational structure, cash basis accounting, captive planning, billing methodology, or any other federal tax related issue.

The policy period for each contract was from January 1, 20XX to January 1, 20XX.
The contracts also listed the aggregate limit of insurance and the premium paid by the total Combined Premium paid by the Named Insured as follows:

Type of Policy	Policy Number	Aggregate Limit	Total Premium	ORG's Premium
Excess Directors & Officers	SECTY	$ 0	$ 0	$ 0
Excess Employment Practices	SECTY	0	0	0
Special Risk-Exp Reimb	SECTY	0	0	0
Legal Expense Reimb	SECTY	0	0	0

Special Risk-Cargo/Transit	SECTY	0	0	0
Special Risk-Loss of Srvc	SECTY	0	0	0
Special Risk – Loss of MajorB2B	SECTY	0	0	0
Excess Pollution	SECTY	0	0	0
Special Risk – Product recall	SECTY	0	0	0
Special Risk – punitive Wrap	SECTY	0	0	0
Regulator Change	SECTY	0	0	0
Special Risk – Tax Liability	SECTY	0	0	0
Total		0	0	0

Each policy identified the Named Insureds as CO-1, CO-2, CO-3; and CO-4, located at Address, City, Texas Zip code

The above amount represents the total direct written premium received for the 12 direct written contracts and the Joint Stop Loss Agreement with CO-8. Under the terms of the Joint Underwriting Agreement and direct written contracts, ORG, as Lead Insurer, received % or $ of the total combined premiums paid by the Named Insureds. In addition, the Named Insureds paid % or $ directly to CO-8, as the Stop Loss Insurer.

ORG	$0	x	0%	=	$ 0
CO-8	$0	x	0%	=	0
Total Combined Direct Written Premium					$ 0

JOINT UNDERWRITING STOP LOSS ENDORSEMENT

With respect of each of the 12 above referenced property and casualty contracts, the taxpayer and CO-8 ("CO-8") entered into an agreement titled, "Joint Underwriting Stop Loss Endorsement." The taxpayer and CO-8 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 endorsement, both parties agreed to underwrite the insurance coverages described in the 12 direct written policies with the Affiliated Businesses. Taxpayer was responsible for payment of part of the claims incurred by the Named Insureds under the direct written contracts, up to certain specified thresholds. If the specified thresholds were met, then CO-8, as the Stop Loss Insurer, became liable for payment of claims up to certain specified limits. If the specified limits for CO-8's payment of claims were exceeded, then the taxpayer again became liable. For 20XX, the Named Insureds paid a total Combined Premium of $0 for the 12 direct written contracts. Of the total Combined Premium paid by the Named Insureds 0% or $0 was paid to the taxpayer and 0% or $0 was paid directly to CO-8 The endorsement effective date is December 8, 20XX. ORG is identified as the "Lead Insurer" and CO-8 as the Stop Loss Insurer. The terms of the endorsement reads as follows:

In exchange for the direct payment of a portion of the total policy premiums specified in the policy declarations and as further discussed below, the Insurers agree to jointly underwrite the policies specified above according to the Attachment Points, Participation Levels, and additional conditions specified herein.

The Stop Loss Insurer ("CO-8") shall have no liability for payment of any claims until two tests are met: (i) the total of all claims reported by the Insured(s) against the above policies must exceed 100% of the Combined Direct Written Premiums for all of the policies specified above; AND THEN

(ii) one of the Attachment Points specified below must be reached for the policies specified above.

The agreement specifies five levels of Attachment Points that make the Stop Loss Insurer liable for claims.

Once a first Attachment Point is reached, the Stop Loss Insurer (CO-8) will be responsible for paying claims in accordance with its Participation Level detailed in paragraph 3. If another Attachment Point is subsequently reached, the subsequent Attachment Points shall be ignored and the Stop Loss Insurer's participation will be dictated by the terms of the first Attachment Point reached.

The Stop Loss Endorsement serves to supplement the terms of the 12 direct written contracts. The Stop Loss Endorsement outlines the risk of the primary and secondary reinsurers of the policies directly written to the Affiliated Businesses.

Under the terms of the Joint Underwriting Endorsement, ORG, Lead Insurer, received 0% of the total combined premium of $0 paid by the Named Insureds. The Named Insureds also paid the remaining 0% of the combined premium directly to CO-8, the Stop Loss Insurer.

QUOTA SHARE REINSURANCE POLICY

ORG executed a Quota Share Reinsurance Policy (#QS20XX) with CO-8 The agreement indicates that CO-8 is located at Address, City, Country, Territory. ORG is identified as a "Reinsurer" and CO-8 is the "Reinsured."

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 CO-

8. 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. CO-8 insured a portion of the direct insurance underwritten by the pool participants using a so-called "stop loss" endorsement. CO-8 participated in over 0± insurance policies with more than 0± insureds. CO-8 blended together its direct written insurance and then reinsured the entire book on a quota share basis with each of the pool participants.

According to the terms ORG, as reinsurer, is to receive a Quota Share Premium from CO-8 in exchange for the assumption of 0% of the risk pool comprised of the stop loss coverages issued during the policy period by CO-8 to all stop loss endorsement policyholders. The policy period runs from January 1, 20XX, through January 1, 20XX.

Schedule 1 of the policy reflects a total of 0 reinsurers participating in the Quota Share Reinsurance Program. CO-8 paid premiums of $0 to the 0 reinsurers. In response to Question 3, of IDR #2, CPA, CPA, indicated that ORG is identified as Reinsurer No. 50. As Reinsurer #50, ORG was contracted to receive a quota share reinsurance policy premium of $0 or 0% of the $0 total premiums.

According to the general ledger, the taxpayer received reinsurance premiums of $0 from CO-8 in 20XX.

The taxpayer relied on the services of CO-9 and CO-10 to establish the premium rating methodology for the direct written contracts and the Quota Share Reinsurance Agreement.

CREDIT INSURANCE COINSURANCE CONTRACT

Finally, ORG executed Credit Insurance Coinsurance Contract with CO-8, an Country, Territory Corp, effective December 8, 20XX, in which ORG agrees to reinsure a prorate share (0%) of "all net retained policies in force on the effective date assumed by CO-8 from Credit

CO-11 an Country corporation. The risks reinsured are the 20XX insurance exposures on all policies of vehicle service contracts direct written by CO-12 in force on January 1, , and subsequently issued, and assumed by Credit CO-11, from CO-14, under its treaty dated January 1, 20XX.

The reinsurance premiums to be paid by CO-8 to ORG shall be ORG's pro rata share (0%) of the earned premiums during the accounting period under each reinsured policy. Earned premiums are the gross premiums charged the insureds plus the unearned premiums at the beginning of the Accounting Period less the unearned premiums at the end of the Accounting Period.

Based on the terms of the agreement, it appears that the Quota Share Reinsurance and Credit Insurance Coinsurance Contract do provide from the assumption of insurance risk from unrelated third parties. According to the general ledger, taxpayer received a reinsurance premium of $0 in 20XX.

Summary for 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%

The organization reported total revenue of $0 on the Form 990-EZ for 20XX. Program Service Revenue was the only source of revenue earned by taxpayer in 20XX. Total revenue was derived from the following sources:

Program Service Revenue:		
Direct Written Premiums	$	0
Quota Share Reinsurance		0
Other Reinsurance		0
Total Premiums	$	0
Investment income		-0-
Gain of Loss on sale of assets		-0-
Other income		-0-
Total Revenue	$	0

During 20XX, the organization opened a checking account (#003) with Bank of State. The account was opened on November 25, 20XX, with an initial deposit of $0, which represented the initial capital contribution made by its parent, Parent CO. for the purchase of 0 shares of $0 par value common stock, Stock Certificate No. 1, dated November 23, 20XX.

Also, on December 22, 20XX, taxpayer received a wire transfer (#1) from the CO-1 for the deposit of the 20XX direct written premium in the amount of $0. The deposit represented 0% of the total combined premium received by ORG from the Named Insureds. The balance of the total, $0 (or 0%) was paid by the CO-1 directly to the Stop Loss Insurer, CO-8, under the terms of the Joint Underwriting Agreement.

No other funds were deposited to the ORG's checking account in 20XX.

Of the total premiums received by the taxpayer in 20XX, 0% of the premiums were generated from the twelve direct written policies with the Named Insured, CO-1; 0% of the premiums are from the Quota Share Reinsurance Risk Pooling 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 the Bank of State checking account ($0) and reinsurance receivables ($0).

20XX Tax Year

The taxpayer filed Form 990, *Return of Organization Exempt From Income Tax*, for the tax year ended December 31, 20XX, claiming to be tax-exempt under IRC 501(c)(15). During the year, the taxpayer continued to operate as a captive company that insured certain property and casualty risks of affiliated business interests. 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 organization wrote the same 12 direct contracts in 20XX that were written in 20XX. All of the contracts reflected the same Named Insureds as CO-1; CO-2; CO-3, and CO-4, located at Address, City, Zip code. ORG is one of two insurers listed in each contract. The contracts list ORG as Lead Insurer and CO-8, as the Stop Loss Insurer.[2] The contracts are silent about the percentage of risk assumed by ORG, as Lead Insurer, and CO-8, as the Stop Loss Insurer. During 20XX, the taxpayer sold and insured the following direct written policies:

20XX DIRECT WRITTEN POLICIES

01. Excess Directors and Officers	SECTY
02. Excess Employment Practices Liability	SECTY
03. Special Risk – Expense Reimbursement	SECTY
04. Legal Expense Reimbursement	SECTY
05. Special Risk – Cargo/Transit	SECTY
06. Special Risk – Loss of Service	SECTY
07. Special Risk – Loss of Major B2B Rel.	SECTY
08. Excess Pollution Liability	SECTY
09. Special Risk - Product Recall	SECTY
10. Special Risk - Punitive Wrap	SECTY
11. Special Risk - Regulatory Changes	SECTY
12. Special Risk - Tax Liability	SECTY

[2] As of the endorsement effective date, CO-4 was added as a Named Insured.

According to the contracts, the policy period runs from January 1, 20XX, to January 1, 20XX. Each policy was an aggregate limit of $0. The combined aggregate limit is $0. According to the terms of the contracts reviewed, the Named Insureds paid a total combined premium of $0 for 20XX.

ORG received 0% of the direct written premium paid by the Named Insureds. The remaining 0% of the direct written premium was paid to CO-8 .

The terms of the 12 direct written contracts for 20XX are described as follows:

1. Directors & Officers Liability

CO-2 has an uninsured directors and officers liability exposure, which could be a serious issue if, for example, allegations of misrepresentation were made against the CO-2 for a marketing effort.

The Company has over 80 employees. In today's litigious environment, it is likely for a company the size of CO-2 with a predominantly blue collar workforce to have several uninsured employment practices liability incidents, and it is probable that one or more of those incidents will result in EEOC investigations and/or loss.

2. Employment Practices Liability

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

3. Expense Reimbursement

Any claims that arise, including claims associated with products liability or product recall, would cause the Company to have costs related to managing a public relations campaign to restore its customers' faith.

Uninsured legal expenses and litigation expense associated with disputes between the insured and its insurers related to claims also represent a risk to the Company. Potentially catastrophic claims are often denied by conventional insurers on financial grounds. A separate policy through the captive for litigation expense would be advisable.

4. Legal Expense Reimbursement

Covers all litigation expenses incurred by the insured resulting for insured's 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.

5. Special Risk CargoTransit

Merchandise worth millions will be shipped in 20XX without separate cargo coverage. The trucking companies have low limitations on the loss or damage of property, which is generally inadequate. A separate cargo policy through the captive insurer is recommended to prevent financial loss from transportation risks.

6. Loss of Services

With CO-2 structured as a limited partnership, there are several partners, whose services are critical to the operations of the business, including Partner-1, Partner-2, Indv-1, and Partner-4. The Company is also has a loss of services exposure associated with its three most productive salespersons; Emp-1, Emp-2 and Emp-3. Should the Company lose the services of any one of these key people, it would not only suffer a business interruption loss while finding a suitable replacement, but it may also incur significant legal expenses enforcing non-compete and confidentiality agreements. (Premium $0)

7. Loss of Major Business to Business Relationships

CO-2 is indemnified from any Business Interruption loss of up to twelve (12) months suffered as a result of the loss of reduction of services of a Major Business-to-Business Relationship(s) as specified as any business relationship that contributes 0% or more to revenue.

8. Excess Pollution Liability

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, clear air, clear 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.

9. Special Risk – Product Recall

If a product is determined to be out of specification, or defective, CO-2 will need to research the extent of the defect within the product line and recall those products that are affected. Given the long supply chain and with several base materials originating outside the United States, the risk of recall in the supply chain is significant.

Form 886-A (Rev. January 1994)	EXPLANATIONS OF ITEMS	Schedule number or exhibit
Name of taxpayer ORG	Tax Identification Number	Year/Period ended 12/31/20XX 12/31/20XX 12/31/20XX

10. Special Risk – Punitive Wrap Liability

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

11. Special Risk - Regulatory Changes

CO-2 is at risk of external factors such as regulatory changes in locksmith licensing and local codes. The Company could incur a significant loss of income if significant changes in locksmith licensing changes interrupt its marketing strategy or if changes in local codes force the company to secure alternative inventory.

12. Special Risk - Tax Liability

The Company is at risk if it were to suffer an adverse decision from an unexpected tax audit with regard to its organizational structure, cash basis accounting, captive planning, billing methodology, or any other federal tax related issue.

The contracts also listed the aggregate limit of insurance and the premium paid by the total Combined Premium paid by the Named Insured as follows:

20XX Contracts

Type of Policy	Policy Number	Aggregate Limit	Total Premium	ORG's Premium
Excess Directors & Officers	SECTY	$ 0	$ 0	$ 0
Excess Employment Practics	SECTY	0	0	0
Special Risk-Exp Reimb	SECTY	0	0	0
Legal Expense Reimb	SECTY	0	0	0
Special Risk-Cargo/Transit	SECTY	0	0	0
Special Risk-Loss of Srvc	SECTY	0	0	0
Special Risk – Loss of MajorB2B	SECTY	0	0	0
Excess Pollution	SECTY	0	0	0
Special Risk – Product recall	SECTY	0	0	0
Special Risk – punitive Wrap	SECTY	0	0	0
Regulator Change	SECTY	0	0	0
Special Risk – Tax Liability	SECTY	0	0	0
Total		0	0	0

Each policy identified the Named Insureds as CO-1, CO-2, CO-3; CO-4, located at Address, City, Zip code

The above amount represents the total direct written premium received for the 12 direct written contracts and the Joint Stop Loss Agreement with CO-8. Under the terms of the Joint Underwriting Agreement and direct written contracts, ORG, as Lead Insurer, received 0% or $0 of the total premiums paid by the Named Insureds. CO-8, the Stop Loss Insurer, received 0% or 0

ORG	$0	x	%	= $	0
CO-8	$0	x	%	=	0
Total Combined Direct Written Premium					$ 0

JOINT UNDERWRITING STOP LOSS ENDORSEMENT

In addition to the 12 direct written contracts executed in 20XX, ORG also executed a Joint Underwriting Stop Loss Endorsement, with CO-8 , whereby both parties agreed to underwrite the insurance coverages described in the 12 direct written policies with the Affiliated Businesses. The endorsement effective date is January 1, 20XX. ORG is identified as the "Lead Insurer" and CO-8 as the Stop Loss Insurer. The terms of the endorsement reads as follows:

1. In exchange for the direct payment of a portion of the total policy premiums specified in the policy declarations and as further discussed below, the Insurers agree to jointly underwrite the policies specified above according to the Attachment Points, Participation Levels, and additional conditions specified herein.

2. The Stop Loss Insurer ("CO-8") shall have no liability for payment of any claims until the total of all claims reported by the Insured(s) against the above policies exceed 0% of the Subject Premiums for all of the policies specified above.

By way of example, if the insured(s) Subject Premiums are $0, the Lead Insurer shall be solely responsible for payment of all claims up to $0, in the aggregate. Once the aggregate for all claims exceed $0, the Stop Loss Insurer will be responsible for paying claims in accordance with its Participation Level detailed in paragraph 3.

3. If the Attachment Threshold is met, the Stop Loss Insurer will pay a Final Settlement which is 0% quota share of the aggregate for all claims

reported by the Insured(s) in excess of the Attachment Threshold, subject to a maximum of 0% of the Subject Premiums.

Provided, however, that nothing in this endorsement shall be interpreted to allow a maximum claim recovery by the Insured(s) in excess of 0% of the Limits of Liability stated in the policy declarations.

If the Attachment Threshold above is not met, the Lead Insurer shall be solely responsible for payment of claims against the specified policies, and the Stop Loss Insurer shall not be responsible for payment of any claims.

The Lead Insurer shall be solely responsible for payment of claims against the specified policies once the Stop Loss Insurer has exhausted its limits in accordance with paragraph 3.A.

4. The Stop Loss Premium rate for this Joint Underwriting Stop Loss Endorsement is 0% of the Subject 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.

By way of example, if the Insured(s) Subject Premiums are $0, then the Insured(s) shall pay a premium of $0 (0%) directly to the Stop Loss Insurer, with the Insured(s) paying a premium of $0 (0%) directly to the Lead Insurer.

The Stop Loss Insurer and Lead Insurer represent and warrant that the only Insureds being issued direct written coverage by the Stop Loss Insurer are clients of Law Firm and CO-13

The Stop Loss Endorsement serves to supplement the terms of the 12 direct written contracts. The Stop Loss Endorsement outlines the risk of the primary and secondary reinsurers of the policies directly written to the Affiliated Businesses.

Under the terms of the Joint Underwriting Endorsement, ORG, Lead Insurer, received 0% of the total combined premium of $0 paid by the Named Insureds. The Named Insureds also paid the remaining 0% of the combined premium directly to CO-8, the Stop Loss Insurer.

QUOTA SHARE REINSURANCE POLICY

ORG executed a Quota Share Reinsurance Policy (#QS20XX) with CO-8. The agreement indicates that CO-8 is located at Address, City, Country, Territory. ORG is identified as a "Reinsurer" and CO-8 is the "Reinsured."

According to the terms ORG, as reinsurer, is to receive a Quota Share Premium from CO-8 in exchange for the assumption of 0% of the risk pool comprised of the stop loss coverages issued during the policy period by CO-8 to all stop loss endorsement policyholders. The policy period runs from January 1, 20XX, through January 1, 20XX.

Schedule 1 of the policy reflects a total of reinsurers participating in the Quota Share Reinsurance Program. CO-8 paid total premiums of $0 to the reinsurers that participated in the program in 20XX. In response to Question 3 of IDR #2, CPA, CPA, identified ORG is identified as Reinsurer # As Reinsurer # ORG was contracted to receive a quota share reinsurance policy premium of $0, or 0% of the $0 total premium.

According to the general ledger, the taxpayer received reinsurance premiums of $0 from CO-8 in 20XX.

The taxpayer relied on the services of CO-9 and CO-10 to establish the premium rating methodology for the direct written contracts and the Quota Share Reinsurance Agreement.

CREDIT INSURANCE COINSURANCE CONTRACT

Finally, ORG executed Credit Insurance Coinsurance Contract with CO-8, an Country, Territory Corp, effective January 1, 20XX, in
which ORG agrees to reinsure a prorate share (0%) of "all net retained policies in force on the effective date assumed by CO-8 from CO-11, an Country corporation under a treaty dated June 1, 20XX with CO-11, a Territory corporation that was merged into CO-11 on January 1, 20XX. The risks reinsured are the 20XX insurance exposures on all policies of vehicle service contracts direct written by CO-12 in force on January 1, 20XX, and subsequently issued, and assumed by Credit CO-11, from CO-14, under its treaty dated January 1, 20XX.

The reinsurance premiums to be paid by CO-8 to ORG shall be ORG's pro rata share (0%) of the earned premiums during the accounting period under each reinsured policy. Earned premiums are the gross premiums charged the insureds plus the unearned premiums at the beginning of the Accounting Period less the unearned premiums at the end of the Accounting Period.

Based on the terms of the agreement, it appears that the Quota Share Reinsurance and Credit Insurance Coinsurance Contract do provide from the assumption of insurance risk from unrelated third parties. According to the general ledger, taxpayer received a reinsurance premium of $0 in 20XX.

Summary for 20XX

Under the terms of the contracts reviewed for 20XX, the taxpayer assumed risk as follows:

Direct Written Premiums	$	0	0%
Quota Share Reinsurance		0	0
Other Reinsurance		0	0
Total Premiums	$	0	%

The organization reported total revenue of $0 on the Form 990 for 20XX. Program Service Revenue represented the primary source of revenue earned by the taxpayer. Total revenue was derived from the following sources during 20XX:

Program Service Revenue:		
Direct Written Premiums	$	0
Quota Share Reinsurance		0
Other Reinsurance		0
Total Premiums	$	0
Investment income		0
Gain of Loss on sale of assets		-0-
Other income:		
Interest on secured loan		0
Total Revenue	$	0

During 20XX, the organization continued to maintain the checking account (#003) with Bank of State. The organization made six deposits to the account totally $0. A list of the deposits was prepared for the case file. The deposits included the quota share reinsurance premium and retention amount received from CO-8 totaling $0. The deposits also the total combined premium due on the direct written contracts. The taxpayer sold the same 12 direct written contracts as in 20XX. However, in 20XX, CO-1, the Named Insured, paid the total combined premium of $0 to ORG, even though the captive was only entitled to 0% of the total premium or $0. Thus, overpaid the direct written premium by $0. The overpayment was subsequently disbursed by taxpayer to CO-8 , for its 0% share as Stop Loss Insurer, on October 6, 20XX, check number , in the amount of $0.

In addition, on October 20, 20XX, CO-1, the Named Insured, paid a second premium for Stop Loss coverage in the amount of $0 to the taxpayer. This payment was also received from the Named Insured in error. This overpayment was returned to CO-1 on October 20, 20XX.

On November 29, 20XX, the organization deposited $0, as a partial payment of the 20XX quota share reinsurance premiums received from CO-8

The last deposit of $0 was made on December 29, 20XX, represented a principal and interest payment on a secured loan made to CO-1. An initial loan was made to CO-1., by taxpayer, in the amount of $0, on November 29, 20XX. According the general ledger account 1, the deposit of $0 included interest of $0, and principal reduction of $0. No other funds were deposited to the taxpayer's checking account in 20XX.

Date	Amount	Source
1/7/20XX	0	20XX Quota Share Reins. Prem. from CO-8
08/31/20XX	0	20XX Retention from CO-8
10/06/20XX	0	20XX Direct Written premiums rec'd from CO-1
10/20/20XX	0	CO-1-Error for Stop Loss
11/29/20XX	0	20XX Quota Share Reins. Prem. from CO-8
12/29/20XX	0	Loan Prin. $0; loan int. $0
	0	Total Deposits for 20XX

Of the total premiums received by the taxpayer in 20XX, 0% of the premiums were generated from the twelve direct written policies with the Named Insureds, CO-1, the CO-2; CO-3, and CO-4; 0% of the premiums are from the Quota Share Reinsurance Risk Pooling 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 the Bank of State checking account ($0) and a notes receivable balance ($0).

20XX Tax Year

The taxpayer filed Form 990, *Return of Organization Exempt From Income Tax*, for the tax year ended December 31, 20XX, claiming to be tax-exempt under IRC 501(c)(15). During the year, the taxpayer continued to operate as a captive company that insured certain property and casualty risks of affiliated business interests. 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.

The organization wrote the same 12 direct contracts in 20XX that were written during the 20XX and 20XX tax years. All of the contracts reflected the same Named Insureds as CO-1; CO-2; CO-3, and CO-4, located at Address, City, State Zip code. ORG is one of two insurers listed in each contract. The contracts list ORG as Lead Insurer and CO-8, as the Stop Loss Insurer.[3] The contracts are silent about the percentage of risk assumed by ORG, as Lead Insurer, and CO-8, as the Stop Loss Insurer. During 20XX, the taxpayer sold and insured the following direct written policies:

20XX DIRECT WRITTEN POLICIES

01. Excess Directors and Officers	SECTY
02. Excess Employment Practices Liability	SECTY
03. Special Risk – Expense Reimbursement	SECTY
04. Legal Expense Reimbursement	SECTY
05. Special Risk – Cargo/Transit	SECTY
06. Special Risk – Loss of Service	SECTY
07. Special Risk – Loss of Major B2B Rel.	SECTY
08. Excess Pollution Liability	SECTY
09. Special Risk - Product Recall	SECTY
10. Special Risk - Punitive Wrap	SECTY
11. Special Risk - Regulatory Changes	SECTY
12. Special Risk - Tax Liability	SECTY

According to the contracts, the policy period runs from January 1, 20XX, to January 1, 20XX. A more detailed description of the policies is reflected on the attached Excel spreadsheet.

Each policy was an aggregate limit of $0. The combined aggregate limit is $0. According to the terms of the contracts reviewed, the Named Insureds paid a total combined premium of $0 for 20XX.

[3] As of the endorsement effective date, CO-4, Corp. was added as a Named Insured.

Form **886-A** (Rev. January 1994)	**EXPLANATIONS OF ITEMS**	Schedule number or exhibit
Name of taxpayer ORG	Tax Identification Number	Year/Period ended 12/31/20XX 12/31/20XX 12/31/20XX

Taxpayer received $0 or 0% of the direct written premium paid by the Named Insureds. The remaining 0% of $0 of the direct written premium was paid to CO-8 .

The terms of the 12 direct written contracts for 20XX are described as follows:

1. Directors & Officers Liability
CO-2 has an uninsured directors and officers liability exposure, which could be a serious issue if, for example, allegations of misrepresentation were made against the CO-2 for a marketing effort.

The Company has over employees. In today's litigious environment, it is likely for a company the size of CO-2 with a predominantly blue collar workforce to have several uninsured employment practices liability incidents, and it is probable that one or more of those incidents will result in EEOC investigations and/or loss. (Total Premium $0)

2. Employment Practices Liability
The Company is potentially at risk for employment practices liability for discrimination, harassment, wrongful termination, or other similar inappropriate act. In some jurisdictions, actions related to civil rights allegations can come from third parties such as customers and independent contractors. (Total Premium $0)

3. Expense Reimbursement
Any claims that arise, including claims associated with products liability or product recall, would cause the Company to have costs related to managing a public relations campaign to restore its customers' faith.

Uninsured legal expenses and litigation expense associated with disputes between the insured and its insurers related to claims also represent a risk to the Company. Potentially catastrophic claims are often denied by conventional insurers on financial grounds. A separate policy through the captive for litigation expense would be advisable. (Total Premium $0)

4. Legal Expense Reimbursement
Covers all litigation expenses incurred by the insured resulting for insured's 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. (Total Premium $0)

5. Special Risk CargoTransit
Over $0 million will be shipped in 20XX without separate cargo coverage. The trucking companies have low limitations on the loss or damage of property, which is generally inadequate. A separate cargo policy through the captive insurer is recommended to prevent financial loss from transportation risks. (Total Premium $0)

6. Loss of Services

With CO-2 structured as a limited partnership, there are several partners whose services are critical to the operations of the business, including Partner-1, Partner-2, Indv-1, and Partner-4. The Company is also has a loss of services exposure associated with its three most productive salespersons; Emp-1, Emp-2 and Emp-3. Should the Company lose the services of any one of these key people, it would not only suffer a business interruption loss while finding a suitable replacement, but it may also incur significant legal expenses enforcing non-compete and confidentiality agreements. (Total Premium $0)

7. Loss of Major Business to Business Relationships

CO-2 is indemnified from any Business Interruption loss of up to twelve (12) months suffered as a result of the loss of reduction of services of a Major Business-to-Business Relationship(s) as specified as any business relationship that contributes 0% or more to revenue. (Total Premium $0)

8. Excess Pollution Liability

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, clear air, clear 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. (Premium $0)

9. Special Risk – Product Recall

If a product is determined to be out of specification, or defective, CO-2 will need to research the extent of the defect within the product line and recall those products that are affected. Given the long supply chain and with several base materials originating outside the United States, the risk of recall in the supply chain is significant. (Total Premium $0)

10. Special Risk – Punitive Wrap Liability

Although the Company carries General Liability and Auto Liability coverage, those policies typically have numerous exclusions the insurers use to decline coverage. Any investigation, even if no negligence is found, could prove very costly. A policy to reimburse the Company for this type of insured defense expense may prove attractive to the Company. (Total Premium $0)

11. Special Risk - Regulatory Changes

CO-2 is at risk of external factors such as regulatory changes in locksmith licensing and local codes. The Company could incur a significant loss of income if significant changes in locksmith licensing changes interrupt its marketing strategy or if changes in local codes force the company to secure alternative inventory. (Total Premium $0)

12. Special Risk - Tax Liability

The Company is at risk if it were to suffer an adverse decision from an unexpected tax audit with regard to its organizational structure, cash basis accounting, captive planning, billing methodology, or any other federal tax related issue. (Total Premium $0)

The contracts also listed the aggregate limit of insurance and the premium paid by the total Combined Premium paid by the Named Insured as follows:

20XX Contracts

Type of Policy	Policy Number	Aggregate Limit	Total Premium	ORG's Premium
Excess Directors & Officers	SECTY	$ 0	$ 0	$ 0
Excess Employment Practics	SECTY	0	0	0
Special Risk-Exp Reimb	SECTY	0	0	0
Legal Expense Reimb	SECTY	0	0	0
Special Risk-Cargo/Transit	SECTY	0	0	0
Special Risk-Loss of Srvc	SECTY	0	0	0
Special Risk – Loss of MajorB2B	SECTY	0	0	0
Excess Pollution	SECTY	0	0	0
Special Risk – Product recall	SECTY	0	0	0
Special Risk – punitive Wrap	SECTY	0	0	0
Regulator Change	SECTY	0	0	0
Special Risk – Tax Liability	SECTY	0	0	0
Total		0	0	0

Each policy identified the Named Insureds as CO-1, CO-2, CO-3; CO-4, located at Address, City,

The above amount represents the total direct written premium received for the 12 direct written contracts and the Joint Stop Loss Agreement with CO-8. Under the terms of the Joint Underwriting Agreement and direct written contracts, ORG, as Lead Insurer, received 0% or $0 of the total premiums paid by the Named Insureds. CO-8, the Stop Loss Insurer, received 0% or 0

ORG	$ 0	x 0%	= $ 0	
CO-8	$ 0	x 0%	= $ 0	
Total Combined Direct Written Premium				$ 0

UNDERWRITING STOP LOSS ENDORSEMENT

In addition to the 12 direct written contracts executed in 20XX, the taxpayer also executed a Joint Underwriting Stop Loss Endorsement, with CO-8 , whereby both parties agreed to underwrite the insurance coverages described in the 12 direct written policies with the Affiliated Businesses. The endorsement effective date is January 1, 20XX. Taxpayer is identified as the "Lead Insurer" and CO-8 as the Stop Loss Insurer. The terms of the endorsement reads as follows:

1. In exchange for the direct payment of a portion of the total policy premiums specified in the policy declarations and as further discussed below, the Insurers agree to jointly underwrite the policies specified above according to the Attachment Points, Participation Levels, and additional conditions specified herein.

2. The Stop Loss Insurer ("CO-8") shall have no liability for payment of any claims until the total of all claims reported by the Insured(s) against the above policies exceed 0% of the Subject Premiums for all of the policies specified above.

By way of example, if the insured(s) Subject Premiums are $0, the Lead Insurer shall be solely responsible for payment of all claims up to $0, in the aggregate. Once the aggregate for all claims exceed $0, the Stop Loss Insurer will be responsible for paying claims in accordance with its Participation Level detailed in paragraph 3.

3. If the Attachment Threshold is met, the Stop Loss Insurer will pay a Final Settlement which is % quota share of the aggregate for all claims reported by the Insured(s) in excess of the Attachment Threshold, subject to a maximum of 0% of the Subject Premiums.

If the Attachment Threshold above is not met, the Lead Insurer shall be solely responsible for payment of claims against the specified policies, and the Stop Loss Insurer shall not be responsible for payment of any claims.

The Lead Insurer shall be solely responsible for payment of claims against the specified policies once the Stop Loss Insurer has exhausted its limits in accordance with paragraph 3.A.

4. The Stop Loss Premium rate for this Joint Underwriting Stop Loss Endorsement is 0% of the Subject 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.

By way of example, if the Insured(s) Subject Premiums are $0, then the Insured(s) shall pay a premium of $0 (0%) directly to the Stop Loss Insurer, with the Insured(s) paying a premium of $0 (0%) directly to the Lead Insurer.

The Stop Loss Insurer and Lead Insurer represent and warrant that the only Insureds being issued direct written coverage by the Stop Loss Insurer are clients of Law Firm and CO-13

The Stop Loss Endorsement serves to supplement the terms of the 12 direct written contracts. The Stop Loss Endorsement outlines the risk of the primary and secondary reinsurers of the policies directly written to the Affiliated Businesses.

Under the terms of the Joint Underwriting Endorsement, the Taxpayer, as Lead Insurer, received 0% of the total combined premium of $0 paid by the Named Insureds. The Named Insureds also paid the remaining 0% of the combined premium directly to CO-8, the Stop Loss Insurer.

QUOTA SHARE REINSURANCE POLICY

ORG executed a Quota Share Reinsurance Policy (#QS20XX) with CO-8 The agreement indicates that CO-8 is located at Address, City, Country, Territory. ORG is identified as a "Reinsurer" and CO-8 is the "Reinsured."

According to the terms, Taxpayer, as reinsurer, is to receive a reinsurance premium from CO-8 in exchange for the assumption of a specified Quota Share of the Risk Pool. Schedule 1 attached to the Quota Share Reinsurance contract showed that CO-8 reinsured its Risk Pool with 69 separate property and casualty companies. ORG is one of the 0 companies that reinsured CO-8's Risk Pool in 20XX. CO-8 paid premiums totaling $0 to the 0 reinsurers.

In Schedule 1, ORG is identified as Reinsurer #0. As Reinsurer #0, ORG contracted to assume 0% of the risk of CO-8's Risk Pool in exchange for a quota share reinsurance premium of $0 (or 0% of $0).

According to the general ledger, the taxpayer received reinsurance premiums of $0 from CO-8 in 20XX.

The taxpayer relied on the services of CO-9 and CO-10 to establish the premium rating methodology for the direct written contracts and the Quota Share Reinsurance Agreement.

CREDIT INSURANCE COINSURANCE CONTRACT

Finally, ORG executed Credit Insurance Coinsurance Contract with CO-8, an Country, Territory Corp, effective January 1, 20XX, in which ORG agrees to reinsure a prorate share (0.6949%) of "all net retained policies in force on the effective date assumed by CO-8 from CO-11, an Country corporation under a treaty dated June 1, 20XX, with Credit CO-11, a corporation that was merged into CO-11 on January 1, 20XX. The risks reinsured are the 20XX insurance exposures on all policies of vehicle service contracts direct written by CO-12 in force on January 1, 2006, and subsequently issued, and assumed by Credit CO-11, from CO-14, under its treaty dated January 1, 20XX.

The reinsurance premiums to be paid by CO-8 to ORG shall be ORG's pro rata share (0%) of the earned premiums during the accounting period under each reinsured policy. Earned premiums are the gross premiums charged the insureds plus the unearned premiums at the beginning of the Accounting Period less the unearned premiums at the end of the Accounting Period.

Based on the terms of the agreement, it appears that the Quota Share Reinsurance and Credit Insurance Coinsurance Contract do provide from the assumption of insurance risk from unrelated third parties. According to the general ledger, taxpayer received a reinsurance premium of $0 in 20XX.

Summary for 20XX

Under the terms of the contracts reviewed for 20XX, the taxpayer assumed risk as follows:

Direct Written Premiums	$	0	0%
Quota Share Reinsurance		0	0
Other Reinsurance		0	0
Total Premiums	$	0	0%

Form **886-A** (Rev. January 1994)	**EXPLANATIONS OF ITEMS**	Schedule number or exhibit
Name of taxpayer ORG	Tax Identification Number	Year/Period ended 12/31/20XX 12/31/20XX 12/31/20XX

The organization reported total revenue of $0 on the Form 990 for 20XX. Program Service Revenue represented the primary source of revenue earned by the taxpayer. Total revenue was derived from the following sources during 20XX:

Program Service Revenue:		
Direct Written Premiums	$	0
Quota Share Reinsurance		0
Other Reinsurance		0
Total Premiums	$	0
Investment income		0
Gain of Loss on sale of assets		-0-
Other income:		
Premium Finance Charges		0
Interest on secured loan		0
Total Revenue	$	0

During 20XX, the organization continued to maintain the checking account (#003) with Bank of State. The organization made eight deposits to the account totaling $0. A list of the deposits was prepared for the case file. The bank statements reflected four deposits of $0. These deposits represented a combination of the direct written premiums of $0 and premium finance charges of $0 for the 12 contracts executed in 20XX. The direct written premiums were received from the CO-1. Although the contracts listed multiple Named Insureds, only one of the entities actually paid the direct written premium to ORG. The following deposits were made to the taxpayer's checking account during 20XX:

Date	Amount	Source of Deposit	Purpose Direct Premium	Finance Charge	Loan Interest
5/13/20XX	0				
5/13/20XX	0	CO-1			
5/13/20XX	0				
6/17/20XX	0				
10/6/20XX	0	CO-1	0	0	
10/6/20XX	0	CO-1	0	0	
10/6/20XX	0				0

12/30/20XX	0			0	0
	0	Total Deposits	0	0	0

The quota share reinsurance premium and credit reinsurance premiums were recorded in the books on the accrual basis. The reinsurance premiums were recognized as income in 20XX, although the actual premiums were not received until 20XX. In response to IDR #1, Item 23, the CPA indicated that ORG received reinsurance premiums from CO-8 as follows:

	Quota Share	Credit Reinsurance
1/31/20XX	$0	
7/17/20XX	0	
20XX		0
Total	0	0

Of the total premiums received by the taxpayer in 20XX, 0% of the premiums were generated from the twelve direct written policies with the Named Insureds, CO-1, the CO-2; CO-3, and CO-4; 0% of the premiums are from the Quota Share Reinsurance Risk Pooling 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 the Bank of State checking account ($0) and a notes receivable balance ($0).

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.

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 June 24, 20XX, seeking retroactive exemption under IRC 501(c)(15), back to November 22, 20XX, the date of incorporation. The application was ultimately withdrawn by Partner-1, President, on September 17, 20XX. The examining agent believes that the application was withdrawn by the taxpayer on the advice on its counsel, Attorney-3, Attorney-1, and , who are affiliated with Law Firm, in City, State. 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 ORG based on the position taken by Rulings and Agreements on applications filed by other clients of Law Firm.

Law Firm 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 laStateering." 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 ORG and an insurance policy are the discounted expected values of the cash flows they provide their Partner-1s. 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[4] (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

[4] 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."

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. Excess Directors & Officers Liability Insurance Policy.

Covers wrongful acts of directors and officers.

Insurance.

2. 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., invasion 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.

3. 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; ORG 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.

4. Special Risk – Legal Expense Reimbursement Insurance Policy

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

Not insurance. Policy is vague as to what liability/contract underlies the need for defense expenses.

5. Special Risk – Cargo/Transit

Covers loss or damage to property that occurs while the property is being shipped.

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

6. Special Risk – Loss of Services Insurance Policy.

Covers the involuntary loss of services for key employees. The covered cause of loss must be involuntary and includes sickness, disability, death, loss of license, resignation or retirement after 14 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.

7. Special Risk-Loss of Major Business to Business Insurance Policy

Covers any business interruption loss of up to 12 months suffered as a result of losing the services of a Major Business-to-Business Relationship (any business relationship that

contributes 10% or more to revenue). Business interruption losses include the impact of lost revenue and the extra expenses involved in finding a replacement Business-to-Business Relationship. The policy will not cover the voluntary loss of a Major Business-to-Business Relationship where the insured initiates the termination of the agreement; the loss of a Major Business-to-Business Relationship that insured did not attempt or intent to replace; or the loss of a Major Business-to-Business Relationship due to insured's substantial non-compliance with the terms and conditions of its contractual agreement with the customer.

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

8. 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.

9. Special Risk – Product Recall

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.

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 12 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.

20XX Policies

ORG issued the same 12 direct written contracts as in 20XX.

20XX Policies

ORG issued the same 12 direct written contracts as in 20XX and 20XX.

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

Contract	Deemed Insurance	Deemed Not Insurance
Excess Directors & Officers	Yes	
Excess Employment Practices		No
Special Risk-Expense Reimbursement		No
Special Risk-Legal Expense Reimbursement		No
Special Risk-Cargo/Transit	Yes	
Special Risk-Loss of Services		No
Special Risk-Loss of Major B2B		No
Special Risk- Excess Pollution		No
Special Risk-Product Recall		No
Special Risk-Punitive Wrap		No
Special Risk-Regulatory Changes		No
Special Risk-Tax Liability		No

We were able to definitively deem only two of the direct written contracts as insurance contracts because they included an insurance risk. Ten of the twelve direct written contracts issued by the taxpayer were deemed not to include an insurance risk; was either a business or investment risk; or we were unable to clearly identify an insurance risk.

Other Insurance Policies

Quota Share Reinsurance Program.

CO-8 participated in over 0± insurance policies with more than 0± insureds. CO-8 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 a Quota Share Premium of $0 from CO-8 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 a Quota Share Premium of $0 from CO-8 in exchange for the assumption of 0% of the risk pool. In 20XX, taxpayer was Reinsurer No. . Again, taxpayer received a Quota Share Premium of $0 from CO-8 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 CO-8 do include the 12 contracts written by ORG Therefore, it is highly likely that the entire pool, which is insured by CO-8 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.

Insurance In Its Commonly Accepted Sense

Staff

As a foreign corporation, taxpayer contracted with CO-6, in Country, Territory, to serve as its Residential Insurance Manager. Taxpayer did not hire or employ staff to conduct an insurance business. During the tax years under consideration, taxpayer did not incur salaries and wages expenses or any other payroll costs.

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 August 30, 20XX response to IDR #1 for the 20XX tax year, the CPA provided a copy of letters from CO-15; CO-9; and CO-10, which was purpose to address the method used for pricing the direct written and reinsurance contracts for the taxable years under consideration. In addition, the CPA provided a copy of a Feasibility Study for ' . and Affiliates, dated October 27, 20XX. The study was prepared by , Inc. The purpose of the study was as follows:

> to evaluate CO-2's desire to explore the option of forming a captive insurer for the purpose of writing coverages tha' are generally unavailable or impractical to obtain in the conventional insurance marketplace. As such, we have started with the captive insurer option and then compared it to other available risk management financing options, all in recognition of the wide range of uninsured risks that CO-2 now has implicitly decided to retain outright.
>
> On page 31, addressed the pricing of the various policies written by taxpayer:
>
> The proposed insured is currently paying $0 annually for its conventional commercial property & casualty insurance program. Since its inception, the proposed insured has paid millions of dollars for these coverages. The underwriting profit made by the various insurers has caused the proposed insured to be concerned about pricing inequity.
>
> The economics of the insurance industry are based on the spread of risk. This means that conventional insurers will spread their risk over many insureds. Some insureds will have more losses than premiums paid, and some will have fewer losses than premiums paid. If underwritten

effectively, the insurers should make a profit by spreading its risk in this fashion.

Most insureds consider themselves as having been very profitable for their conventional insurers, and feel they are effectively "subsidizing" the poorer risks. This leads to a belief that there is pricing inequity in past and present policies and quotes, as most take exception to paying top dollar rates for standardized coverage in order to subsidize other insureds who do not share the same level of commitment to loss control.

The Service concluded that the letters and feasibility study do not address the method of pricing the specific direct written and reinsurance contracts that ORG 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.

Use of Assets

Taxpayer engaged in investment activities that are typical of insurance companies. Based on the review of the Form 990 returns, taxpayer made two loans to the Affiliated Businesses to whom it executed the direct written contracts. Loans were made during the 20XX and 20XX tax years. The amount of the outstanding loan receivable balances represented the total percentage of assets as follows:

	12/31/20XX	12/31/20XX	12/31/20XX
Loan balance	-0-	$ 0	$ 0
Total Assets	$ 0	$ 0	$ 0
Percentage	0%	0%	0%

The loan due from the Affiliated Businesses was still outstanding as of 20XX.

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 zero 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 zero and 0% 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 10% of the insured's risks was added to the single-insured scenario of Situation1. The Service concluded in both of the above scenarios that insurance did not exist because there lacked a sufficient number of insureds. The small number of insureds produced an insufficient pool of premiums to distribute any insurance risk.

With respect to the contracts reviewed during the tax years under audit, the Service concluded that the contracts between the taxpayer and the CO-1, CO-2, CO-3, CO-4, and CO-5, the Named Insureds, 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 businesses are owned and controlled by beneficial Partner-1s of the taxpayer, Partner-1 and Partner-2. Of the 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 three insureds does not constitute risk distribution because of the very high likelihood of the insureds 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, % 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 0% of the direct written premiums were paid by one of the five Affiliated Businesses. Taxpayer 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 one of the five insured parties, CO-1 Although the direct written contracts covered five Named Insureds, taxpayer did not receive separate premium payments from the other four entities. The taxpayer did not receive direct written premiums from an adequate pool of insureds. Thus, the contracts between the taxpayer and the Affiliated Business Interests lack 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 the five Affiliated Businesses, CO-1, CO-2, CO-3, CO-4, and CO-5 Because the risk is too heavily concentrated in the Affiliated Business Interests, it is clear that any losses paid by the taxpayer would be those of the Affiliated Business Interests and not from an unrelated third party. In addition, since only one of the Affiliated Businesses paid all of the direct written premiums received by the taxpayer during the years under audit, the Service concluded that losses incurred by the Affiliated Business Interests were paid only from the premiums paid to the taxpayer by the single entity, CO-1 In other words, the arrangement between the taxpayer and the Affiliated Business Interests 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 50% of the total risks assumed by the taxpayer is with affiliated businesses that are owned and controlled by Partner-1 and Partner-2, beneficial Partner-1s of the taxpayer.
Only the premiums received by taxpayer for the Excess Directors & Officers and the Special Risk – Cargo/Transit contracts were deemed to be actual premium income, for the tax years under examination, because the contract involved an insurance risk. Thus, the Excess Directors & Officers and Cargo/Transit contracts were deem to be contracts of insurance. The amounts received by taxpayer under the remaining 10 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 the Affiliated Business Interests to the taxpayer 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 CO-8

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. Based on our 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 2006-42 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 the Affiliated Business Interests lack the requisite risk distribution. Therefore, the taxpayer does not qualify as an insurance company.

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, ten of the twelve 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 taxpayer in 20XX for ten of the twelve direct written contracts are not considered insurance premiums. The amount received by taxpayer for two of the twelve direct written contracts was deemed to be a premium because only these two contracts included an insurance risk. For 20XX and 20XX, taxpayer issued the same twelve direct written contracts. Again, only two of the twelve direct written contracts were deemed to include an insurance risk. The rest of the contracts were not insurance contracts because they did not coverage an insurance risk. The contracts covered either a business or investment risk. During the taxable years under consideration, ORG received amounts that the Service deemed to be direct written and reinsurance premiums as follows:

20XX

Contract			Premium
Direct Written Contracts:			
Excess Directors & Officers Liability			
$0	x	0%	$0

Special Risk – Cargo/Transit	
$ 0 x 0%	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
Direct Written Contracts:	
Excess Directors & Officers Liability	
$0 x 0%	$ 0
Special Risk – Cargo/Transit	
$ x %	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
Direct Written Contracts:	
Excess Directors & Officers Liability	
$0 x 0%	$ 0
Special Risk – Cargo/Transit	
$0 x 0%	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

Premiums received by taxpayer for each contract in 20XX were not requested during the examination.

The amounts received by ORG under the remaining contracts were not for insurance 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, the amount paid for each contract, by CO-1, do 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 CO-8 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. Gross receipts were computed under Notice 2006-42.[5] 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. We concluded that the taxpayer did not meet the 50% gross receipts test described in IRC 501(c)(15) and Notice 2006-42 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 the Affiliated Businesses lack the requisite risk distribution. Therefore, the taxpayer does not qualify as an insurance company.

ORG does not meet the new gross receipts test imposed by Notice 2006-42. For tax years ended December 31, 20XX, through December 31, 20XX, gross receipts did not exceed the

[5] Under Notice 2006-42, only gains from the sale of capital assets are included in gross receipts.

$600,000 limitation. However, premium income was not greater than 50% of the gross receipts generated for each year.

ORG is NOT a member of a controlled group as defined in section 1563(a) of the Internal Revenue Code. Therefore, only the receipts generated by ORG were included in the "gross receipts test" used to determine qualification for treatment as a tax-exempt entity under IRC 501(c)(15).

Application of Foreign Corporation Tax Provisions

The administrative file for the original Form 1024 application filed by taxpayer included a copy of the IRC 953(d) election filed by the Company on February 26, 20XX. However, the IRS has no record that the election was approved. As of the date of this examination, it appears that the Service still had not approved the IRC 953(d) election filed years ago. Taxpayer withdrew the initial Form 1024 application on September 17, 20XX.

IRC 953(a)(1) defines insurance income to mean income which is attributable to the issuing or reinsuring of an insurance or annuity contract, and would be taxed under subchapter L if such income were the income of a domestic insurance company. Therefore, any premium income received by a CFC could qualify.

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 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 company does not meet the requirements to make the IRC 953(d) election, and thus, is not a domestic corporation, the company should be treated as a "controlled foreign corporation," and the provisions of Subpart F of the Internal Revenue Code (sections 951-965) should apply. However, the Company did not generate any passive sources of income such as dividends, interest, royalties, rents or annuities, during the tax year under audit.

The subpart F provisions apply to foreign corporations that qualify as controlled foreign corporations ("CFCs"). IRC 957 defines a CFC as a foreign corporation with regard to which more than 50% of the total combined voting power of all classes of stock entitled to vote or the

total value of the stock is owned by U.S. shareholders. A U.S. shareholder, in turn, is defined under IRC 951(d) as a U.S. person who owns 10% or more of the total combined voting power of all classes of stock entitled to vote of the foreign corporation. Therefore, a corporation with regard to which more than 50% of the vote or value is owned by U.S. persons who individually own 10% or more or the vote will qualify as a CFC under IRC 957.

IRC 953(a)(1) defines insurance income to mean income which is attributable to the issuing or reinsuring of an insurance or annuity contract, and would be taxed under subchapter L if such income were the income of a domestic insurance company. Therefore, any premium income received by a CFC could qualify as insurance income for purposes of IRC 953 even though the CFC fails to qualify as an insurance company under subchapter L.

IRC 953(a)(2) of the Code excepts "exempt insurance income (as defined in subsection (e)" from the definition of insurance income. However, to qualify as exempt insurance income, such income must be derived by a qualifying insurance company. A qualifying insurance company is defined as a company that "is engaged in an insurance business and would be subject to tax under subchapter L if it were a domestic corporation.

IRC 953(e)(3)(C) states that income derived from U.S. sources does not qualify for exemption.

If a CFC does not qualify as an insurance company under subchapter L, it will not meet the definition of a qualifying insurance company for purposes of IRC 953(e). Thus, none of its insurance income will be exempt insurance income.

A Preliminary Report, Form 5701, *Notice of Proposed Adjustments*, was mailed to CPA, the taxpayer's CPA and authorized representative, on April 24, 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.

TAXPAYER'S POSITION:

A response to the Preliminary Report was received from CPA, CPA, on June 5, 20XX. In the response, the CPA summarized that the taxpayer disagreed with the Service's conclusions that (1) ORG's insurance operations lacked the requisite insurance risks to constitute insurance; (2) the contracts lack the requisite risk distribution; and (3) the Service ignored more than 30 years of well-established tax law, as well as the Service's hundreds of rulings.

The CPA argued the following points:

1. All of the policies written by ORG insure against risk of loss due to fortuitous events; and there is no presence of business or investment risk coverage in any of the policies. All coverages written by ORG are for pure insurance risks.

2. The Quota Share Reinsurance contracts underwritten by ORG were contracts for insurance, as all of the risks reinsured were pure insurance risks.

3. The Service appears to reach a predetermined result not supported by the facts. By raising the "lack of insurance risk" issue, the Service demonstrates a clear lack of knowledge of customary insurance products as well as the insurance industry in general.

4. The Service ignored the important fact that when taking into account all the insurance policies and reinsurance contracts, all of the premiums were attributable to many thousands of independent, unrelated risks of hundreds or thousands of unrelated insureds.

5. The CPA 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.

6. The CPA stated that the Service conducted no meaningful examination of risk distribution in its audit of ORG. 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 also cited *AMERCO, Inc. v. Commissioner, 9th Cir. Nov. 1992.*

7. The Service ignored 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. Instead, the Service now relies inappropriately on the fact that there is an overlap in common beneficial Partner-1ship between ORG and the direct written insureds in reaching its conclusion that the direct written contracts are not valid insurance. In doing so, the Service attempts to resurrect the economic family theory it repudiated over ten years ago.

8. The CPA argues the Service's analysis of risk distribution is incomplete. The Service ignores the numerous unrelated risks that ORG insures. Courts have

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

9. The Tax Court's position on risk distribution is explained further in the recent opinion, *Rent-A-Center, Inc. & Affiliated Subsidiaries v. Commissioner, 142 T.C. 1 (20XX).* The Tax Court found that risk distribution was present, even though Rent-A-Center's captive, Legacy, insured primarily only three companies, with one company representing between 55% and 70% of premiums in the relevant years. This finding was based on the significant number of stores, employees and vehicles insured by Legacy; this is, the actual risk exposure units covered by the contracts and not the mere number of insureds.

10. CPA 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. There has been no intervening change in law to account for the Service's disparate tax treatment between ORG 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. 20XX-9, Section 9).

11. CPA, CPA cited an expert report of ORG's insurance program for 20XX through 20XX, prepared by Dr. a former Professor of Insurance and Risk Management at the Wharton School of the University of Pennsylvania. was the expert witness for the taxpayer in the Harper case. In his report on ORG, concluded that the program offered a sufficient level of risk distribution to qualify as insurance. concluded that the risk distribution in the insurance program of ORG far exceeds the standard set forth in the Harper case.

Government's Response to Taxpayer's Position:

After reviewing the response to the Preliminary Report received from CPA, CPA, on June 5, 20XX, the Service's initial position is unchanged. ORG's primary and predominant business in tax years 20XX, 20XX, and 20XX, was not insurance because the direct written contracts issued by the company lacked insurance risks and the requisite risk distribution. Thus, the company did not operated as an insurance company as described in Subchapter L of the Code. Because the company was not an insurance company, it also fails to meet the requirements for tax-exempt status under section 501(c)(15) of the Code, for the tax years ended December 31, 20XX, December 31, 20XX, and December 31, 20XX.

Taxpayer's Position:
In the second paragraph, page 1, of the June 5, 20XX response to the agent's preliminary report, the CPA stated that the audit conclusion reached by the Service is based upon a number of unsupported and factually incorrect positions, including that ORG's insurance operations lacked the requisite insurance risk to constitute insurance and 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 ORG, 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 ORG was to assume risks of affiliated businesses partially owned and controlled by officers of ORG and beneficial Partner-1s of the affiliated businesses. Approximately % of the risk assumed by ORG was that of the affiliated businesses. ORG did not assume risk of or receive direct written premiums from non-affiliated businesses or the 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, ORG's primary and predominant activity is not insurance as described in Subchapter L of the Internal Revenue Code.

Taxpayer's Position:
On pages 2 through 4, the CPA described the terms of 0 direct contracts written by ORG during the tax years in question. The CPA claims that the contracts are insurance in the commonly accepted sense; the risk covered are insurance risks; and the contracts do not lack risk distribution.

Government's Position:
The government's position with respect to the status of the direct written contracts remains unchanged. The Service contends that only the Excess Directors & Officers Liability Insurance and the Special Risk – Cargo/Transit policies covers insurance risks, and thus are valid contracts of insurance. The remaining ten direct written contracts are not contracts of insurance in the commonly accepted sense because the contract covers business or investment risks, and not an insurance risk.

Taxpayer's Position:
On Page 4 of the Taxpayer's position, the CPA cited the *Harper Group & Subsidiaries v. Commissioner*, 96 T.C. 45(1991) to support the argument that ORG qualifies as an insurance company. The CPA cited 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 0 percent is irrelevant on the issue whether sufficient risk distribution is present because of the significant presence of unrelated risks. The CPA made the following statement in the last paragraph on page 4 of the June 5, 20XX response:

> In its preliminary report, the Service merely states, that due to approximately 0 percent of premiums being direct written premiums for coverages written to four insureds, which in fact owned no interest in ORG, there is a lack of adequate risk distribution. The Service's position ignores the important fact that when taking into account all the insurance policies and reinsurance contracts, all of the premiums were attributable to many thousands of independent, unrelated risks of hundreds or thousands of unrelated insureds.

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

Even if the CPA claimed that insurance exists under the rationale in the Harper case, where approximately 30% of the risk assumed by ORG 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 were 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.

Form **886-A** (Rev. January 1994)	**EXPLANATIONS OF ITEMS**	Schedule number or exhibit
Name of taxpayer ORG	Tax Identification Number	Year/Period ended 12/31/20XX 12/31/20XX 12/31/20XX

Taxpayer's Position:
On page 5, paragraph 3, of the taxpayer's position, the CPA stated that the Service conducted no meaningful examination of risk distribution in its audit of ORG. 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. Using the amounts reported on the Form 990 returns, the taxpayer assumed risks as follows:

20XX		
Direct Written Premiums	$ 0	0%
Quota Share Reinsurance Assumed	0	0
Other Reinsurance Assumed	0	0
Total	$0	0%

20XX		
Direct Written Premiums	$ 0	0%
Quota Share Reinsurance	0	0
Other Reinsurance	0	0
Total Premiums	$0	0%

20XX		
Direct Written Premiums	$ 0	0%
Quota Share Reinsurance	0	0
Other Reinsurance	0	0
Total Premiums	$ 0	0%

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 years under audit.

Taxpayer's Position:
In paragraph 3, page 6, the CPA cited the recent Tax Court decision, Rent-A-Center, Inc. & Affiliated Subsidiaries v. Commissioners, 142 T.C. 1 (20XX), as further evidence of the Court's position that risk distribution is based on the actual risk exposure units covered by the contracts and not by the mere number of insureds.

Government's Response:
The opinion and dissent in this court case emphasized the following points:

- In 2002, the IRS likewise abandoned its position that there is a per se rule against the deductibility of brother-sister "premiums," concluding that the characterization of such payments as "insurance premiums" should be governed, not by a per se rule, but by the facts and circumstances of the particular case. *Rev. Rul. 2002-90, 2002-2 C.B. 985*; accord *Rev. Rul 2001-31, 2001-1 C.B. at 1348* ("The Service may continue to challenge certain captive insurance transactions based on the facts and circumstances of each case.").

- Respondent's position in the instant cases is consistent with the ruling position the IRS has maintained for the past 12 years--namely, that characterization of intragroup payments as "insurance premiums" should be determined on the basis of the facts and circumstances of the particular case.

Revenue Ruling 2005-40 describe facts and circumstances in which payments received by captives under "parent-subsidiary" and "brother-sister" arrangements would and would not qualify as an IRC 162 deduction for federal income 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 a single 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. Although the direct written contracts list four Named Insureds, ORG received premiums from only one of the entities, CO-1 The direct written premiums were paid by the single Insured and were not paid by or allocated amongst the other three businesses named in the contracts. Such an arrangement is not insurance but a form of self-insurance.

Taxpayer's Position:
On page 6, paragraph 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 a single 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. Although the direct written contracts list four Named Insureds, ORG received premiums from only one of the entities, . The direct written premiums paid by the single Insured were not paid by or allocated amongst the other three businesses named in the contracts. 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 50 percent of the insuring company's business, the company will be an insurance company within the meaning of IRC Sections 816 and 831, and the premium payments may be deductible under Code Sec. 162, assuming the requirements for deduction are otherwise satisfied.

Taxpayer's Position:
On page 7, paragraph 3, the CPA stated that 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. There has been no intervening change in law to account for the Service's disparate tax treatment between ORG and such similarly situated taxpayers. According, the Service has violated its own procedures and mandate to provide a uniform application of existing tax law. See Rev. Proc. 20XX-9, Section 9.

Government's Position:
Each taxpayer stands alone. The audit of the activities and books and records of ORG and the outcome of such audit stands alone. The issues raised by the Service with respect to the audit of ORG are based on available facts.

Taxpayer's Position:
On page 7 of the response, the CPA stated that the taxpayer's position is further supported by the expert opinion of Dr. former professor of Insurance and Risk Management at the Wharton School of the University of Pennsylvania. examined ORG's insurance program for the 20XX through 20XX years and concluded that the program offered a sufficient level of risk distribution to qualify as insurance. He also concluded that the risks transferred in the insurance policies issued by ORG are ordinary insurable risks and represent insurance in the commonly accepted sense.

Government's Response:
The opinions expressed by Dr. about the Insurance Program did not change the Government's position with respect to the activities conducted by ORG during the tax years covered by this examination report.

CONCLUSION:

The Government concluded that the contracts executed by ORG do not constitute contracts of insurance, and the arrangement entered into by ORG lacks the requisite element of risk distribution. Therefore, ORG's primary and predominant activity was not issuing of insurance or annuity contracts or the reinsuring of risks underwritten by insurance companies. Thus, ORG is not an insurance company as described in Subchapter L of the Code, and does not qualify for treatment as a tax-exempt entity under section 501(c)(15) of the Internal Revenue Code, for the tax year ended December 31, 20XX, December 31, 20XX, and December 31, 20XX.

In addition, the taxpayer's IRC 953(d) election is not valid because the taxpayer is not an insurance company, and the Service never approved the election.