Internal Revenue Service

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Department of the Treasury
Washington, DC 20224

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Person To Contact:
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PLR-140116-09

Date:
December 21, 2010

Taxpayer =

Risk Retention Group =

State X =
Number A =
Number B =
Number C =
Holding Company =
Number D =
Number E =
Number F =
State Y =
Figure 1 =
Figure 2 =
Figure 3 =

Dear :

This ruling responds to the letter submitted by your authorized representative, requesting a ruling that amounts paid by Taxpayer to the Risk Retention Group (the "RRG") described in Taxpayer's request constitute insurance premium payments

deductible as business expenses under § 162 of the Internal Revenue Code (the "Code").

FACTS

Taxpayer represents as follows:

Taxpayer is a medical practice, providing physician services to hospital centers and surgery centers. It is structured as a limited liability company and has elected to be treated as a partnership for federal income tax purposes. Taxpayer is domiciled in State X and engages approximately Number A physicians and mid-level providers.

Taxpayer, together with Number B other medical practices (collectively, the "Practices"), proposes to form the RRG to issue insurance policies providing (1) medical malpractice liability coverage for active physicians and practices that are underserved by the commercial professional malpractice insurance market and (2) "tail" or extended reporting endorsement coverage for retired physicians and practices.

Number C Practices (but not Taxpayer) are limited liability companies whose sole owner is another Practice and which are treated as disregarded entities for federal tax purposes. Taxpayer is majority-owned by Holding Company, which in turn has varying degrees of ownership interests in most of the other Practices. Of the remaining Practices, which are not treated as disregarded entities for federal tax purposes, Holding Company owns a majority interest in Number D Practices (including Taxpayer), has a minority interest in Number E Practices, and has no ownership interest in Number F Practices.

The Practices plan to form the RRG in State Y. The initial members/owners of the RRG will be the Practices, each of which will own an equal share in the proposed RRG. As the core operations grow and expand, additional entities are expected to join the membership and attain a pro-rata share of the RRG's ownership. Taxpayer represents that the RRG will be adequately capitalized, according to the requirements of State Y.

The RRG will be registered, admitted, and regulated by the State Y Department of Insurance, and licensed by such as an association captive insurance company. It will be managed internally and it will maintain all responsibility for underwriting, policy service, claims and risk management, financial management and reporting, and reinsurance procurement and administration.

The RRG intends to issue policies with standard limits of liability up to Figure 1 per claim and Figure 2 annual aggregate to physicians providing medical services under the relevant Practice's contract; however, if an individual state requires higher limits, the RRG intends to issue policies up to those higher limits of liability. For the standard

policies, the RRG intends to retain the risk for the first Figure 3 per claim and to purchase reinsurance for liabilities in excess of Figure 3.

All physician and medical provider risks insured by the RRG are to be underwritten using a short form application. Physicians will be screened for training, board certification, claims history, substance abuse history, licensure and privilege issues, and criminal convictions. The Practices will endeavor to hire, and the RRG to insure, an ideal physician profile.

Taxpayer represents that premiums for both medical professional liability coverage and any extended reporting (or "tail") coverage will be determined at arms-length. The RRG will engage a risk management and actuarial consulting firm ("Consultant"), to develop premium rates, by state, for RRG risks. Underwritten physicians will be rated according to a scoring system based on training, loss history, and other underwriting factors. All base premium rates will be developed by Consultant after a review of the rates of the market leaders in each state and rates will continue to be developed utilizing publicly available data of other insurers within each respective state. The goal of the pricing of premiums for the various states and business segments will be parity relative to expected losses.

Taxpayer also represents that no individual Practice will encompass more than 15 percent of the total risk pool of the RRG; that there will be no guarantees by any of the Practices in favor of the RRG with any bank, lending institution, or other entity; and that there will be no loans from the RRG to Taxpayer or any other Practice.

LAW AND ANALYSIS

Section 162(a) of the Code provides, in part, that there shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business.

Section 1.162-1(a) of the Income Tax Regulations (the "Regulations") provides, in part, that among the items included in business expenses are insurance premiums against fire, storms, theft, accident, or other similar losses in the case of a business.

Section 263 of the Code states that no deduction is allowed for any amount paid for permanent improvements or betterments made to increase the value of any property or estate.

Section 1.263(a)-4(d)(3)(i) of the Regulations states that a taxpayer must capitalize prepaid expenses. Example 1 of 1.263(a)-4(d)(3)(iii) provides as follows:

> Prepaid insurance. N corporation, an accrual method taxpayer, pays $10,000 to an insurer to obtain three years of coverage under a property and casualty

> insurance policy. The $10,000 is a prepaid expense and must be capitalized under this paragraph (d)(3). Paragraph (d)(2) of this section does not apply to the payment because the policy has no cash value.

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

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 the insurance payment. Risk distribution incorporates the statistical phenomenon known as the law of large numbers. Distributing risk allows the insurer to reduce the possibility that a single costly claim will exceed the amount taken in as premiums and set aside for the payment of such a claim. By assuming numerous relatively small, independent risks that occur randomly over time, the insurer smooths out losses to match more closely its receipt 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 Humana, the United States Court of Appeals for the Sixth Circuit held that arrangements between a parent corporation and its insurance company subsidiary did not constitute insurance for federal income tax purposes. The court also held, however, that arrangements between the insurance company subsidiary and several dozen other subsidiaries of the parent (operating an even larger number of hospitals) qualified as insurance for federal income tax purposes because the requisite risk shifting and risk distribution were present. But see Malone & Hyde, Inc. v. Commissioner, 62 F.3d 835 (6th Cir. 1995) (concluding the lack of a business purpose, the undercapitalization of the offshore captive insurance subsidiary and the existence of related party guarantees established that the substance of the transaction did not support the taxpayer's characterization of the transaction as insurance). In Kidde Industries, Inc. v. United States, 40 Fed. Cl. 42 (1997), the United States Court of Federal Claims concluded that an arrangement between the captive insurance subsidiary and each of the 100 operating subsidiaries of the same parent constituted insurance for federal income tax purposes. As in Humana, the insurer in Kidde insured only entities within its affiliated group during the taxable years at issue.

In Rev. Rul. 2002-90, 2002-2 C.B. 985, P, a domestic holding company, owns all of the stock of 12 domestic operating subsidiaries that operated on a decentralized basis. Together the 12 subsidiaries have a significant volume of independent, homogeneous risks. P, for a valid non-tax business purpose, formed S as a wholly-

owned insurance subsidiary. P provides S with adequate capital. S directly insures the professional liability risks of the 12 operating subsidiaries owned by P. S charges the 12 subsidiaries arms-length premiums for professional liability coverage, which are established according to customary industry rating formulas. There are no parental (or other related party) guarantees of any kind made in favor of S. S does not loan any funds to P or to the 12 operating subsidiaries. In all respects, the parties conduct themselves in a manner consistent with the standards applicable to an insurance arrangement between unrelated parties. S does not provide coverage to any entity other than the 12 operating subsidiaries. None of the operating subsidiaries have liability coverage for less than 5%, nor more than 15%, of the total risk insured by S. S retains the risks that it insures from the 12 operating subsidiaries. The Service concludes that, based on all the facts and circumstances, the arrangements between S and each of the 12 operating subsidiaries of S's parent constitute insurance for federal income tax purposes and, therefore, the amounts paid for professional liability coverage by the 12 domestic operating subsidiaries to S are “insurance premiums” deductible under § 162 of the Code.

CONCLUSION

Based on the information submitted and the representations made, we conclude that, for purposes of determining the deduction for ordinary and necessary business expenses under § 162 of the Code, the amounts paid by Taxpayer to the RRG for medical malpractice liability insurance—including extended reporting coverage—are treated as “insurance premiums,” to the extent that such premiums are for current year coverage.

CAVEATS

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

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

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

A copy of this letter must be attached to any income tax return to which it is relevant. Alternatively, taxpayers filing their returns electronically may satisfy this requirement by attaching a statement to their return that provides the date and control number of the letter ruling.

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

Sincerely,

/S/

SHERYL B. FLUM
Branch Chief, Branch 4
Office of the Associate Chief Counsel
(Financial Institutions & Products)

cc: