

Internal Revenue Service

Department of the Treasury

Index Number: 115.00-00

Washington, DC 20224

Number: **199924046**

Person to Contact:

Release Date: 6/18/1999

Telephone Number:

Refer Reply To:

CC:DOM:FI&P:1-PLR-121280-98

Date:

March 24, 1999

Legend:

Company	=
Country <u>a</u>	=
State <u>b</u>	=
Year <u>c</u>	=
<u>d</u>	=

Dear

This is in response to your letter dated November 16, 1998, and subsequent correspondence including proposed Bylaws for the Company, requesting a ruling on behalf of the Company. We have been requested to rule that income of the Company will be excluded from gross income under § 115 of the Internal Revenue Code.

FACTS

The Company is a mutual insurance company incorporated under the laws of Country a. The Company intends to reincorporate as a captive insurer in State b for the Year c policy year, and the Company's headquarters will be relocated to the United States.

The Company was incorporated for the sole purpose of acting as a reinsurer to its members (Members). Presently, the Company has d members. Each of these Member's income is excluded from gross income under § 115 and is an insurance pool formed by public housing authorities. Members provide indemnification or financial protection to the public housing authorities for such risks as comprehensive general liability, public officials liability, auto liability and property damage. The Company will indemnify its Members on an excess basis for all sums which they become legally obligated to pay, subject to the limits, terms and conditions set forth in individual agreements (Reinsurance Agreement).

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After reincorporating, membership will be limited to: (a) a political subdivision of a State (as defined in § 1.103-1(b) of the Income Tax Regulations); (b) an organization constituting an integral part of a political subdivision of a State; or (c) an entity whose income is excluded from gross income under § 115. Each Member, as a condition of its initial or continued membership, must pay a premium, or increase its current premium, to the Company to establish reserves required under the law of State b (Reserve Fund Contribution).

The Company will be funded by the Reserve Fund Contributions, ongoing premiums paid by the Members, the investment income earned thereon, and the proceeds of any reinsurance the Company is able to obtain. The payment of the Reserve Fund Contribution is in addition to any ongoing premium payments.

Upon termination of the Company, a Member will be entitled to the return of its Reserve Fund Contribution to the extent it is not needed to pay losses and expenses, subject to any obligations of the Member to the Company. In the event that the Company makes distributions, in liquidation or otherwise, each Member shall be entitled to its proportional share.

The Company will purchase reinsurance to protect itself from specific and aggregate losses in excess of its retention. Each Member will be required to pay an annual premium for reinsurance coverage. The premiums will be determined by the Board of Directors of the Company in its discretion, by reference to initial rating principles which take into consideration each Member's exposure and the aggregate reinsurance limits purchased. The rating principles may be amended upon the affirmative vote of two-thirds of the Company's Board of Directors (Directors).

A Member's Reinsurance Agreement will have a mandatory term. Upon the expiration of the term, each Reinsurance Agreement may be extended. However, a Member may refuse to extend reinsurance coverage by giving timely notice. A Member's Reinsurance Agreement may be terminated by the Company, with cause, upon the affirmative vote of a majority of the Directors present and voting. Members who withdraw or do not renew their memberships forfeit all rights to distributions, in liquidation or otherwise, other than the Member's Reserve Fund Contribution. Members who withdraw or do not renew their memberships forfeit all interests or other investment income on the Reserve Fund Contributions.

The Company's profits will either be returned as a distribution to the Members or used to build the surplus of the Company. The Company may utilize any increase in surplus to reduce premium rates and/or to increase the limits of coverage offered.

Each Member will be entitled to share in any distribution of Company profit based on its proportional share, calculated as follows: the total amount of the distribution multiplied by a fraction, the numerator of which is the sum of the amounts

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paid by the Members to the Company multiplied by the number of months from the date of such payment to the date of the distribution, and the denominator of which is the sum of such amounts calculated for all Members. In the event of the dissolution of the Company, all its remaining assets, after the payment of debts and obligations, shall be distributed to its Members.

Once the Company is incorporated in State b, the Board of Directors of the Company will be elected by its Members, and at least one Director will be a State b resident. The Company will enter into an agreement with a management company in State b to provide general management services to the Company, under the control and supervision of the Board, including operation of the Company's office and administrative and statistical services.

LAW & ANALYSIS

Section 115(1) provides that gross income does not include income derived from any essential governmental function and accruing to a state or political subdivision thereof.

In Rev. Rul. 77-261, 1977-2 C.B. 45, income from a fund, established under a written declaration of trust by a state, for the temporary investment of cash balances of the state and its political subdivisions, was excludable from gross income under § 115. That ruling reasoned that the investment of positive cash balances by a state or political subdivision thereof in order to receive yield on the funds until needed to meet expenses is a necessary incident of the power of the state or political subdivision to collect taxes or other revenue for use in meeting governmental expenses. In addition, the ruling also provided that since the state and its participating political subdivisions had an unrestricted right to their proportionate share of the investment fund's income, the fund's income accrues to them within the meaning of § 115(1). Rev. Rul. 77-261 pointed out that it may be assumed that Congress did not desire in any way to restrict a state's participation in enterprises that might be useful in carrying out those projects desirable from the standpoint of the state government which, on a broad consideration of the question, may be the function of the sovereign to conduct. In addition, pursuant to § 6012(a)(2) and the underlying regulations, the investment fund, being classified as a corporation that is subject to taxation under subtitle A of the Code, was required to file a federal income tax return each year.

Rev. Rul. 90-74, 1990-2 C.B. 34, holds that income of an organization formed, operated and funded by political subdivisions of a state to pool their casualty risks is excluded from gross income under §115(1). The ruling also holds that income of such an organization formed to pool risks in lieu of purchasing insurance to cover their public liability, workers' compensation, or employees' health obligations is excluded under § 115(1) if private interests do not, except for incidental benefits to

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employees of the participating state and political subdivisions, participate in or benefit from the organizations.

The Company was created to provide reinsurance for its Members with respect to certain liabilities and property damage risks. All Members of the Company must be a political subdivision of a state, an integral part of a political subdivision, or an entity whose income is excluded from gross income under § 115. The type of benefits provided are similar to those mentioned in Rev. Rul. 90-74. The Company, therefore, like the organization described in Rev. Rul. 90-74, performs an essential governmental function within the meaning of § 115(1).

Income of the Company will be used solely to provide benefits to its Members. Only a political subdivision of a state, an integral part of a political subdivision, or an entity whose income is excluded from gross income under § 115 is allowed to become a Member of the Company. In the event of the dissolution of the Company, all its remaining assets, after the payment of debts and obligations, shall be distributed to its Members. Private interests do not participate in or benefit from income of the Company. See Rev. Rul. 90-74. Therefore, income of the Company accrues to a state or political subdivision thereof within the meaning of § 115(1).

CONCLUSION

Based on the information submitted, and representations made, we rule that commencing with the Year c policy year, after the Company incorporates in State b and adopts the proposed Bylaws as submitted, income of the Company will be excluded from gross income under § 115.

We note that § 6012(a)(2) and § 1.6012-2(a)(1) provide, in general, that every corporation, as defined in § 7701(a)(3), subject to taxation under subtitle A is required to file an income tax return regardless of whether it has taxable income or regardless of its gross income. See Rev. Rul. 77-261. Accordingly, the Company will be required to file an income tax return pursuant to § 6012(a)(2).

Except as specifically ruled upon above, no opinion is expressed or implied as to the federal income tax consequences of the transactions described above under any other provision of the Code. For example, no opinion is expressed or implied whether the Company is an insurance company under the Code. This ruling is directed only to the taxpayer requesting it. Section 6110(k)(3) provides that it may not be used or cited as precedent.

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

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Sincerely yours,

Assistant Chief Counsel
(Financial Institutions & Products)

By: _____
Alvin J. Kraft
Chief, Branch 1

Enclosures:
Copy of this letter
Copy for § 6110 purposes