INDEPENDENT TAX OPINION

Important Note to Advisors

The information contained in this Tax Opinion is proprietary in nature and is being provided to you, as advisor to a client, in connection with your client's consideration of entering into a captive insurance company arrangement. This Tax Opinion will include certain information concerning potential participation in a captive arrangement with Oxford Insurance Company, LLC ("Oxford").

As a condition to your being furnished this information in such capacity as the Receiving Party, you agree to treat any information concerning Oxford, its affiliates, its businesses or its members in accordance with the provisions of the Oxford Insurance Companies Confidentiality and Non-Circumvention Agreement ("Agreement").

Authority to review the enclosed evaluation materials is conditioned upon your providing a signed copy of the Agreement confirming your agreement with its conditions and contents.

Oxford Research Group, LLC provides educational and research activities regarding possible participation in a captive insurance company and assists in review of the feasibility of entering into such an arrangement. Based on the results of a feasibility analysis, Oxford Research Group, LLC will help you and your client determine whether a captive insurance arrangement is appropriate.

CONFIDENTIAL DOCUMENT

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CIRCULAR 230 DISCLOSURE: To ensure compliance with the requirements imposed by the Internal Revenue Service, we inform you that this opinion was not intended to be used, and cannot be used by any taxpayer, for the purpose of avoiding penalties that may be imposed on the taxpayer. This advice was written to support the promotion or marketing of the transaction or matter addressed within this opinion. You should seek advice based on your particular circumstances from an independent tax advisor.

October 15, 2013

Mr. Kevin E. Myers
Vice President and Treasurer
Oxford Insurance Company LLC
1925 Lovering Avenue, Suite C
Wilmington, DE 19806

Re: Tax Opinion for Oxford Insurance Company LLC

Dear Mr. Myers:

Oxford Insurance Company LLC (the "Company" or "you") has requested our opinion concerning:

A. Whether each Reinsurer (as defined herein), will be an "insurance company" within the meaning of Section 831(c) of the Internal Revenue Code of 1986, as amended (the "Code") (in conjunction with Section 816(a) of the Code) and taxable as such under the Code.

B. Whether the Pooling Arrangement (defined herein) constitutes insurance for federal income tax purposes, such that amounts paid as premiums to Series A (as defined herein) by the Series Members (as defined herein) or persons related to the Series Members for Direct Policies (as defined herein) issued are deductible as "insurance premiums" under Section 162 of the Code.

Based on the following discussion and application of authority:

A. We believe that each Reinsurer should be considered an "insurance company" and should be taxable as such under Section 831(c) of the Code (in conjunction with Section 816(a) of the Code).

B. We believe that the Pooling Arrangement should constitute insurance for federal income tax purposes, such that amounts paid as premiums to Series A by the Series Members or persons related to the Series Members for Direct Policies issued are deductible as "insurance premiums" under Section 162 of the Code.

In rendering an opinion, we have reviewed the following principal documents:

1. Certificate of Formation of Oxford Insurance Company LLC dated September 2, 2010

2. State of Delaware Certificate of Amendment changing only the Registered Office and Registered Agent of a Limited Liability Company dated August 7, 2012

3. Limited Liability Company Agreement of Oxford Insurance Company, LLC dated September 2, 2010

4. Form of Affirmation and Statement of Business Purpose of Series ___ of Oxford Insurance Company LLC

5. Form of Series A of Oxford Insurance Company LLC, Wilmington, Delaware, Declaration Page

6. Form of Actual Net Loss Insurance Policy

7. Form of Reinsurance Agreement between Oxford Insurance Company LLC, Series A and Oxford Insurance Company, LLC, Series ___

8. Form of Designation of Series of Oxford Insurance Company LLC

9. Form of Certificate of the Secretary of Oxford Insurance Company, LLC certifying authorizing resolutions with respect to Series Members

10. Form of Series Agreement for Series of Oxford Insurance Company LLC, a Delaware Limited Liability Company

We have examined and relied upon an officer's certificate of the Company dated October 15, 2013. We have also relied on such other certificates, documents and records as we have deemed necessary or advisable for purposes of this opinion.

I. Facts and Assumptions

A. *Factual summary*

The factual pattern of the proposed transaction relating to the tax issues addressed in this letter is summarized as follows:

1. Oxford Insurance Company LLC (the "Company") is a limited liability company formed pursuant to and in accordance with the Delaware Limited Liability Company Act (6 Del. C. §18-101, *et. Seq.*) (the "Act") and is owned fifty percent (50%) each by two individuals who, for purposes of this opinion, will be referred to as Member A and Member B.

2. The Company received a certificate of authority dated November 29, 2010, as a special purpose captive insurance company pursuant to Section 6902(28) of the Revised Delaware Captive Insurance Company Act (the "Captive Statute"), and has established multiple series, including Series A and the Reinsurers (defined herein) (the "Series") pursuant to Section 18-215 of the Act, and is subject to an administrative order pursuant to Section 6915A of the Captive Statute.

3. Eighty-two (82) additional Series of the Company have been formed and have entered into Reinsurance Agreements (defined herein) (hereinafter referred to as "Reinsurers") and are owned by individuals or entities (each a "Series Member"), all of whom are unrelated to one another or to Member A or Member B.

4. The first Series ("Series A") is wholly-owned by the Company.

5. Series A issues policies insuring business interruption, loss of income and other scheduled risks of Series Members (or entities owned directly or indirectly by any such Series Member) (collectively, the "Direct Policies").

6. Series A has entered into a series of reinsurance agreements with the Reinsurers (the "Reinsurance Agreements") pursuant to which each Reinsurer will act as a reinsurer of a portion of the directly-written risks of Series A for which the Reinsurer will be paid a reinsurance premium. The series of Reinsurance Agreements to which Series A Reinsurers are parties is sometimes referred to in this letter as the "Pooling Arrangement" and is further summarized as follows:

(a) Series A has entered into the Reinsurance Agreements with the Reinsurers.

(b) The Reinsurance Agreements are "quota share" reinsurance arrangements pursuant to which Series A writes Direct Policies to each Series Member and/or related persons thereto and cedes to each respective corresponding Reinsurer forty-nine percent (49%) of the risks insured under such Direct Policies issued to the Series Member or any related person thereto ("Related Party Risks") as well as a pro rata quota share of risks insured

under Direct Policies issued to persons other than such Series Member or related person thereto ("Unrelated Party Risks") that equals fifty-one percent (51%) of the total risks assumed by such Reinsurer.

(c) Each Reinsurer receives a specified share of total reinsurance premiums from Series A computed so that in each taxable year, forty-nine percent (49%) of the reinsurance premiums earned by the Reinsurer relate to Related Party Risks and fifty-one percent (51%) of the reinsurance premiums earned by the Reinsurer relate to Unrelated Party Risks.

(d) The aggregate reinsurance premiums payable to each Reinsurer as a result of accepting reinsurance of the directly-written risks of Series A will be equal in amount to the premium payable by the Reinsurer's Series Member or any related person thereto with respect to the Direct Policies issued to the Series Member or any related person thereto.

B. *Factual assumptions*

In addition to the factual matters set forth above, we have also assumed, with your permission, that the following factual matters are true and correct at all times with respect to which our advice pertains:

1. The Company and each Series are licensed as an insurance companies under Delaware law.

2. The Company, Series A and each Reinsurer is in compliance with the applicable pronouncements of the Financial Accounting Standards Board and generally accepted accounting principles with respect to accounting for its operations.

3. The Company, Series A and each Reinsurer is capitalized in compliance with applicable insurance laws and regulations, and its capitalization will be maintained with respect to all corporate formalities and requirements of any and all relevant jurisdictions.

4. Each Reinsurer is adequately capitalized relative to the risks assumed in the Reinsurance Agreement to which the Reinsurer is a party.

5. The Company, Series A and each Reinsurer has been organized and is operated for bona fide business purposes and Series A and each Reinsurer has a substantial purpose (apart from federal income tax effects) for entering into the transactions reflected in the Direct Policies and Reinsurance Agreements, and has changed their economic position in a meaningful way (apart from federal income tax effects) by entering into such transactions.

6. None of the Series Members is related to one another or to Member A or Member B through entity ownership or family relationships.

7. None of the Series Members or any related person thereto will guarantee the obligations of Series A or of any Reinsurer.

8. Neither Series A nor any of the Reinsurers will lend back to its insureds or Series Members amounts that the insureds or Series Members have paid as premiums.

9. The Pooling Arrangement always has and always will be conducted with at least seven (7) Series Members. If at any time the Pooling Arrangement has or will be conducted with only seven (7) Series Members, each Series Member represented or will represent at least five percent (5%) of the total insured risks.

10. During each taxable year, none of the Reinsurers will engage in any trade or business other than that of participating in insurance arrangements as reinsurers as described above.

11. The income, expense, assets, liabilities and capital of each Series are accounted for separately from the income, expense, assets, liabilities and capital of any other Series.

II. Law and Authority

A. *Deductibility of Insurance Premiums*

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. Treasury Regulation Section 1.162-1(a) provides, in part, that among the items included in business expenses are insurance premiums insuring against fire, storms, theft, accident, or other similar losses in the case of business. Neither the Code nor the regulations define the term "insurance" or "insurance contract."

B. *"Insurance Company", "Insurance" and "Insurance Contract"*

Under the Code, an insurance company is "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."[1] While neither the Code nor applicable Treasury Regulations define "insurance" or "insurance contract," case law explains the indicia of an insurance contract.

Courts have stated that for a contractual arrangement to constitute insurance for federal income tax purposes, it must involve an "insurance risk" and that both risk-shifting and risk-

[1] I.R.C. § 831(c) in conjunction with I.R.C. § 816(a).

distributing must be present.[2] Additionally, the arrangement must constitute insurance in the commonly accepted sense.[3]

To constitute an insurance risk, a risk must be the risk of economic loss.[4] The risk must contemplate fortuitous occurrence of a stated contingency and must not be merely an investment or business risk.[5] In some of its rulings, the Internal Revenue Service ("Service") has stated that the insured risks are homogeneous though no specific authority currently requires that the insured risks must be homogeneous.[6]

C. *Risk-shifting and Risk-distributing*

In *Helvering v. LeGierse,* the Supreme Court stated that "insurance" requires "risk-shifting" (from the insured's perspective) and "risk-distributing" (from the insurer's perspective).[7] These factors, risk-shifting and risk-distributing, have been identified in court decisions as well as pronouncements by the Service, as elements necessary for a determination that an arrangement is "insurance."[8] "'Risk-shifting' means one party shifts his risk of loss to

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[2] *See Helvering v. LeGierse,* 312 U.S. 531 (1941) (involving the simultaneous issuance of an annuity contract and a "single premium" life insurance policy and whether the insured's beneficiary was entitled to treat the life insurance death benefit as excludible under the federal estate tax law in effect at the time. *Helvering* is universally recognized as the starting point of analysis in cases involving the question of whether an arrangement purporting to be an "insurance" policy will be respected as such, often, if not usually, in the context of whether "premiums" paid by an "insured" are deductible for federal income tax purposes. In PLR 200746003 (November 16, 2007), the Internal Revenue Service described *Helvering* as the "bedrock for evaluating whether an arrangement constitutes insurance" for tax purposes.)

[3] *Id.*

[4] *Allied Fidelity Corp. v. Comm'r*, 572 F.2d 1190 (7th Cir. 1978).

[5] *Comm'r v. Treganowan*, 183 F.2d 288 (2nd Cir 1950).

[6] In Notice 2005-49, 2005 I.R.B. 14, the Service invited public comments on, among other things, "the relevance of homogeneity in determining whether risks are adequately distributed for an arrangement to qualify as insurance." The Revenue Rulings which examine the question of whether an arrangement is insurance for tax purposes contain a factual statement that the risks that were being examined were homogeneous (*see, e.g.*, Revenue Ruling 2005-40, 2005-2 C.B. 4; Revenue Ruling 2002-90, 2002-2 C.B. 985; Revenue Ruling 2002-89, 2002-2 C.B. 984), but the Service has not issued any rulings on how to determine if risks are homogeneous. Likewise, there are no reported court cases examining how to determine whether risks are considered homogeneous or to what extent homogeneity of risks is a factor, much less a requirement, in determining whether risk distribution is present.

[7] 312 U.S. at 539.

[8] *See, e.g., Beech Aircraft Corp. v. U.S.*, 797 F.2d 920, 922 (10th Cir. 1986) (stating "[a]n arrangement without the elements of risk-shifting and risk-distributing lacks the fundamental inherent in a true contract of insurance").

another, and 'risk-distributing' means that the party assuming the risk distributes his potential liability, in part, among others."[9]

1. *Risk-shifting*

In general terms, risk-shifting involves the transfer of the impact of a potential economic loss from the insured to the insurer. "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."[10] The question of whether an insured has shifted the risk of loss to an insurer has become problematic where the insurer and the insured are related to each other. Courts have held that risk-shifting is not present where the insured enters into a transaction with its wholly-owned captive insurer if only the risks of the parent are insured.[11] Notwithstanding the foregoing, courts have held that if a captive insurance company underwrites a significant amount of risks from "unrelated" parties, the parent-insured can shift the economics of its risks to the wholly-owned captive insurer.[12] While courts have found adequate risk shifting with greater than twenty-nine percent (29%) unrelated business,[13]

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[9] *Id.*

[10] Revenue Ruling 2008-8, 2008-5 I.R.B. 340 (describing the definition of risk shifting as "established law").

[11] *Stearns-Roger Corp. v. United States*, 774 F.2d 414 (10th Cir. 1981); *Carnation Co. v. Comm'r*, 640 F.2d 1010 (9th Cir. 1981).

[12] *See, e.g., Sears, Roebuck & Co. v. Comm'r*, 972 F.2d 858 (7th Cir. 1992) (Sears wholly owned Allstate Insurance Company and other subsidiaries; Allstate collected more than $5 billion in premiums annually from unrelated insureds, which accounted for ninety-nine percent (99%) of its annual premiums; Allstate charged Sears $14 million annually in exchange for a variety of insurance coverages; held, Sears shifted its risk of loss as required by *LeGierse)*; *Amerco, Inc. v. Comm'r*, 979 F.2d 162 (9th Cir. 1992) (Amerco was a holding company owning a number of subsidiaries, including the U-Haul System and a "captive" insurance company, Republic Western Insurance Company; Republic Western wrote a variety of coverages at normal commercial rates to Amerco affiliates (comprising 26 to 48 percent of Republic Western's total gross premiums) with gross premiums for unrelated business constituting the remaining 74 to 52 percent; held: that "a parent and its subsidiaries can shift risk to a captive insurer, where that insurer has significant unrelated business"); *The Harper Group v. Comm'r*, 979 F.2d 1341 (9th Cir. 1992) (the taxpayer was the parent corporation of a corporate group that owned a captive insurance company; the captive received 29 to 33 percent of its premiums for the years at issue from policies issued to unrelated parties; held: the captive's total business was sufficient to determine there had been adequate risk shifting; the court recognized that "there is a point at which the amount of outside business is insubstantial, so true insurance does not exist"); *Ocean Drilling & Exploration Co. v. United States*, 988 F.2d 1135 (Fed. Cir. 1993) (ODEC, an oil and gas drilling company unable to obtain full coverage of its drilling rigs through existing insurance markets, formed a Bermuda captive insurance company in 1968; noting that "unrelated business operated to reduce the amount of risk to which plaintiff was exposed," the court found sufficient risk shifting and distribution with unrelated business of approximately 44 and 66 percent).

[13] *The Harper Group v. Comm'r*, 979 F.2d 1341 (9th Cir. 1992).

one case found insufficient unrelated business where only two percent (2%) of the premiums were from unrelated parties.[14]

Initially, the Service took the position that corporations that were wholly owned subsidiaries of the owner of a captive insurance company were related to the captive insurance company as members of the same economic family. Several courts, however, reached the conclusion that wholly owned subsidiaries of the owner of a captive insurance company were not related to the captive insurance company.[15] In Revenue Ruling 2001-31,[16] the Service indicated that it will no longer apply the economic family theory to determine whether corporations were related or unrelated to a captive insurance company.

2. *Risk-distributing*

"Risk-distributing" means that a "party assuming the risk distributes his potential liability, in part, among others."[17] In Revenue Ruling 2008-8, [18] the Service stated: "Risk distributing necessarily entails a pooling of premiums, so that a potential insured is not in significant part paying for its own risks". In *Humana Inc. v. Commissioner'*, the Sixth Circuit found that where a captive insurer insured several separate but related corporations and the losses could be spread among entities within the affiliated group of companies, sufficient risk distribution existed.[19]

3. *Revenue Rulings on Risk-shifting and Risk-distributing*

In Revenue Ruling 2002-89,[20] the Service concluded that where the insured risks of a parent corporation were less than fifty percent (50%) of the total risks of its wholly owned captive insurance company, the requisite risk-shifting and risk-distributing to constitute insurance for federal income tax purposes were present. The ruling also concluded that where the risks from unrelated parties represented ten percent (10%) of the total risk of a subsidiary captive insurer, such risks were insufficient to cause the arrangement between the parent and subsidiary to be treated as insurance for tax purposes.

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[14] *Gulf Oil Corp. v. Comm'r,* 89 T.C. 1010 (1987), aff'd, 914 F.2d 396 (3rd Cir. 1990).

[15] *Humana, Inc. v. Comm'r,* 881 F.2d 247 (6th Cir. 1989); *Kidde Industries v. US*, 40 Fed. Cl. 42 (Ct. Cl. 1997); *Hospital Corporation of America and Subsidiaries v. Comm'r* 109 T.C. 21 (1997).

[16] Rev. Rul. 2001-31, 2001-1, C.B. 1348.

[17] *Amerco, Inc. v. Comm'r*, 979 F.2d 162 (9th Cir. 1992).

[18] Revenue Ruling 2008-8, 2008-5 I.R.B. 340 (*citing Humana, Inc.*, 881 F.2d at 257).

[19] *See* generally, *Humana, Inc.*, 881 F.2d 247.

[20] Rev. Rul. 2002-89, 2002-2 CB 984.

In Revenue Ruling 2002-90,[21] the Service analyzed a parent holding company of twelve (12) subsidiary operating companies. The parent formed a wholly owned domestic insurance company to insure the risks of the twelve (12) operating subsidiaries. None of the operating subsidiaries had coverage for less than five percent (5%), nor more than fifteen percent (15%), of the total risks insured by the captive insurance company. The Revenue Ruling concludes that the parent corporation's ownership of the twelve (12) operating subsidiaries and its ownership of the captive insurance company did not affect the conclusion that the arrangements are insurance for federal income tax purposes. While not directly stated in the ruling, implicit in the conclusion is that where each insured has coverage for at least five percent (5%) and no more than fifteen percent (15%) of the total insured risks that the requirements of risk-shifting and risk-distribution have been met.

In Revenue Ruling 2002-91,[22] the Service addressed the circumstance where the insureds co-own the captive insurance company. In the ruling, none of the owners owned more than fifteen percent (15%) of the group captive or more than fifteen percent (15%) of the vote on any corporate governance issue and, thus, no owner controlled the group captive. In addition, no owner's risks insured by the group captive exceeded fifteen percent (15%) of the total risks insured by the group captive. The Service stated that even though the group of insureds was small, there existed a real possibility that each owner would sustain a loss in excess of the premiums it paid.

From the rulings of the Service, the following standards can be distilled:

1. A parent corporation that wholly owns a captive insurance company will be classified as a related party but any other corporation which is owned by the parent will not be classified as a related party.

2. Where a captive insurance company insures more than fifty percent (50%) unrelated business risks a parent-insured can constitute up to forty-nine percent (49%) of the insured risks and the captive insurance company will still satisfy the risk-shifting and risk-distributing requirements to be classified as an insurance company for federal income tax purposes.

3. A captive insurance company can insure as few as seven (7) insureds[23] provided each insured represents at least five percent (5%) of the total insured risks and still satisfy the risk-shifting and risk-distributing requirements to be classified as an insurance company for federal income tax purposes.

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[21] Rev. Rul. 2002-90, 2002-2 CB 985.

[22] Rev. Rul. 2002-91, 2002-2 CB 991.

[23] 100%/15% = 6.667, rounded up to 7.

4. And, if the standards above are met, all of the insureds can be related corporations.

D. *Reinsurance*

In Revenue Ruling 2009-26,[24] two scenarios were presented in which one insurance company contracted with a second insurance company to provide indemnity reinsurance. In the first situation, the first insurance company reinsured with the second company the contracts it had entered into with ten thousand (10,000) unrelated policyholders. The second company had adequate capital to meet its obligations under the contract, operated at arms-length, with the first insurance company, and the transaction was the second company's only business during the taxable year. The Service concluded that even though this arrangement was the second company's only business during the tax year, the requirements of risk-shifting and risk-distributing were met because there was adequate risk-shifting and risk-distributing between the first company and the original policyholders and the second company was simply reinsuring those risks. In the second situation, the first insurance company only transferred the contract of one policyholder to the second company. In addition to that one policyholder, the second company also assumed risks of other insurance companies in the same line of business (commercial multiple peril line). Since the second company also assumed risks under agreements with other insurance companies during the year, the requirements of risk-shifting and risk-distributing were met as to the second company, even though it covered the first insurance company's risk with respect to a single policyholder. In each situation, the Service concluded that the second company qualified as an insurance company within the meaning of Code Section 831(c).

E. *Series LLCs*

Under current law, there is little specific guidance regarding whether a series in a series limited liability company ("Series LLC") is treated as an entity separate from other series or the Series LLC, or whether the company and all of its series should be treated as a single entity for federal tax purposes.

In Revenue Ruling 2008-8,[25] the Service considered whether insurance written by a cell of a protected cell company (similar to a series in a Series LLC) constitutes insurance for tax purposes. The Service considered two situations and looked at the facts pertaining to the cell in each case in considering whether there was sufficient risk-shifting and risk-distributing for the arrangements to constitute insurance. In the first situation, a protected cell company that wholly owned the preferred stock of one of its own cells entered into an arm's-length arrangement in which the cell insured the professional liability risks of the protected cell company. The ruling found that the arrangement between a protected cell company and a cell

[24] Rev. Rul. 2009-26, 2009-38 IRB 366.

[25] Rev. Rul. 2008-8, 2008-5 IRB 340.

is analogous to an arrangement between a parent and its wholly-owned subsidiary, which, in the absence of unrelated risk, lacks the requisite risk-shifting and risk-distributing to constitute insurance for federal income tax purposes. In the second situation, the cell insured twelve (12) operating subsidiaries of the owner of the cell. Each subsidiary represented at least five percent (5%) and no more than fifteen percent (15%) of the total risk insured by the cell. The Service concluded that the subsidiaries' risks were shifted to the cell of the protected cell company and distributed within that cell and the arrangements constituted insurance for federal income tax purposes.

In Notice 2008-19,[26] the Service indicated its intent to set forth proposed guidance on when a protected cell company would be treated as an insurance company separate from any other entity, and requested comments. The Notice stated:

> The proposed guidance would include a rule to the effect that a cell of a protected cell company would be treated as an insurance company separate from any other entity if:
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> (a) the assets and liabilities of the cell are segregated from the assets and liabilities of any other cell and from the assets and liabilities of the protected cell company such that no creditor of any other cell or of the protected cell company may look to the assets of the cell for the satisfaction of any liabilities, including insurance claims (except to the extent that any other cell or the protected cell company has a direct creditor claim against such cell); and
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> (b) based on all the facts and circumstances, the arrangements and other activities of the cell, if conducted by a corporation, would result in its being classified as an insurance company within the meaning of Code Sections 816(a) or 831(c).

In 2010, Treasury released proposed regulations on the classification for federal tax purposes of a series of a domestic series organization such as a Series LLC (the "Proposed Regulations").[27] The Proposed Regulations have not yet been adopted as final regulations but finalizing these regulations is on the Treasury's 2012-2013 Priority Guidance Plan. The Proposed Regulations provide that while a series is treated as a separate entity formed under local law, whether the series is recognized as a separate entity for federal tax purposes is determined under Treas. Reg. § 301.7701-1 and general tax principles.

Under Treas. Reg. § 301.7701 and general tax principals, an entity includes a contractual arrangement where the participants carry on a trade, business, financial operation

[26] Notice 2008-19, 2008-13 IRB 669.

[27] REG-119921-09 (September 13, 2010).

or venture and divide the profits.[28] Code Section 7701(a)(3) and Treas. Reg. § 301.7701-2(b)(4) provide that an arrangement that qualifies as an "insurance company"[29] is a corporation for federal tax purposes. The Service has also concluded that an insurance company includes an arrangement that conducts insurance business, whether or not the arrangement is an entity under state law.[30] However, an arrangement may not be recognized as an entity for federal tax purposes if, among other reasons, it has no business purpose other than tax avoidance.[31]

The question whether a corporation is recognized for federal tax purposes was addressed by the Supreme Court in Moline Properties[32] where the Court held that so long as a corporation was formed for a purpose that is the equivalent of business activity or the corporation actually carries on a business, the corporation remains a taxable entity separate from the shareholders.

Despite the fact the Proposed Regulations have not been adopted, under current statutes, regulations and statements of the Service a series in a Series LLC will be treated as a corporation so long as the operations of the series constitute an insurance company and the series was formed for a business purpose other than tax avoidance.

F. *Economic Substance*

Under the economic substance doctrine, a court may deny tax benefits arising from transactions that do not result in a meaningful change to the taxpayer's economic position other than a reduction in federal income tax.[33] Congress enacted new Code Section 7701(o) which codifies the common law "economic substance doctrine" as part of the Health Care and Education Reconciliation Act of 2010.[34] Pursuant to Code Section 7701(o), a transaction shall be treated as having economic substance only if (i) the transaction changes in a meaningful way (apart from federal income tax effects) the taxpayer's economic position, and (ii) the taxpayer

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[28] Treas. Reg. § 301.7701-1(a)(2). An entity other than a corporation that has a single member can elect to be treated as a corporation and if it does not elect is a separate entity for tax purposes. Treas. Reg. § 301.7701-3.

[29] Pursuant to I.R.C. § 816(a) and 831(c).

[30] Bulletin No. 2010-45, 2010-45 I.R.B. at 628, citing Treas. Reg. 1.801-3(a)(1).

[31] *Bertole v. Comm'r*, 103 T.C. 501 (1994); *Aldon Homes, Inc. v. Comm'r*, 33 T.C. 582 (1959).

[32] *Moline Properties, Inc. v. Comm'r*, 319 U.S. 436 (1943).

[33] *Killingsworth v. Comm'r*, 864 F.2d 1214, 1216 (5th Cir. 1989) (stating it is a well settled rule of law that transactions that lack economic substance will not be recognized for tax purposes).

[34] Health Care and Education Reconciliation Act of 2010 (P.L. 111-152, March 30, 2010).

has a substantial purpose (apart from federal income tax effects) for entering into the transaction.[35]

To satisfy the economic substance requirement, a taxpayer can rely on the profit potential of the transaction to document a change in the taxpayer's economic position in a meaningful way. Code Section 7701(o)(2) states that when a taxpayer relies on the profit potential of the transaction to satisfy the economic substance requirements of 7701(o), then the present value of the reasonably expected pre-tax profit from the transaction must be "substantial" in relation to the present value of the expected net tax benefits. For this purpose, fees and transaction expenses are required to be taken into account in determining the pre-tax profit.

In addition to demonstrating profit potential, a taxpayer can rely on other standards to support a conclusion that the transaction changes the taxpayer's economic position in a meaningful way. Code Section 7701 does not provide any further guidance on what constitutes a meaningful change in the taxpayer's position. However, the Service clarified in Notice 2010-62[36] that it will rely on prior case law in determining whether the two-prong conjunctive test of Code Section 7701(o)(1) has been met; but, the Service will challenge taxpayers who rely on prior case law that determined the economic substance had been met merely because it satisfied one prong of the test.

Notice 2010-62 also states that Code Section 7701(o)(1) only applies to a transaction to which the economic substance doctrine is relevant and the Service will continue to analyze when the economic substance doctrine will apply as it did prior to the enactment of Code Section 7701(o). If authorities, prior to the enactment of Code Section 7701(o), provided that the economic substance doctrine was not relevant to whether certain tax benefits are allowable, the Service will continue to take the position that the economic substance doctrine is not relevant to whether these tax benefits are allowable.

At least one case applied the pre-Section 7701(o) economic substance doctrine to a captive insurance company. In *United Parcel Services of America, Inc.* ("*UPS*"), the court applied the economic substance doctrine to a captive insurance company so it is likely the new Code Section 7701(o) standard will apply to the analysis of a captive insurance company.[37] Accordingly in order to sustain deductions pursuant to Code Section 162 of the Code, a Series Member will likely need to satisfy the standards of Code Section 7701(o).

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[35] A new strict liability penalty under Code Section 6662 imposes a penalty for an underpayment attributable to any disallowance of claimed tax benefits by reason of a transaction lacking economic substance, as defined in new section 7701(o), or failing to meet the requirements of any similar rule of law. The penalty rate is twenty percent (20%) (increased to forty percent (40%) if the taxpayer does not adequately disclose the relevant facts affecting the tax treatment in the return or a statement attached to the return).

[36] Notice 2010-62, 2010-40 IRB 411.

[37] *UPS of America, Inc.*, 254 F. 3d 1014 (11th Cir. 2001).

Citing the Supreme Court in *Frank Lyon Co. v. United States*,[38] the Eleventh Circuit in *UPS* found economic effect in a captive insurance arrangement where UPS entered into an insurance agreement that resulted in a genuine obligation enforceable by an unrelated party.[39] Similarly, while evaluating economic substance in a non-captive insurance arrangement, the Third Circuit in *ACM Partnership v. Comm'r.* acknowledged, in a footnote, that where a transaction objectively affects a taxpayer's net economic position, legal relations, or non-tax business interests, it will not be disregarded merely because it was motivated by tax considerations.[40]

The legislative history of Code Section 7701(o) states in relevant part:

> The provision is not intended to alter the tax treatment of certain basic business transactions, that under longstanding judicial and administrative practice are respected, merely because the choice between meaningful economic alternatives is largely or entirely based on comparative tax advantages.[41]
>
> If the realization of the tax benefits of a transaction is consistent with the Congressional purpose or plan the tax benefit were designed by Congress to effectuate, it is not intended that such tax benefits be disallowed.[42]

The presence of risk-shifting and risk-distributing are also important to an analysis of economic effect because the mere mechanics of risk-shifting and risk-distributing involve

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[38] *Frank Lyon Co. v. United States*, 435 U.S. 561 (1978), where the Court refused to deem a sale leaseback a sham in part because the lessor had accepted a real, enforceable debt to an unrelated bank.

[39] In *UPS*, the court found there were meaningful economic effects on a taxpayer's position when UPS used a captive company to insure packages it shipped. UPS charged its customers "excess-value charges" to directly insure any packages shipped that had a declared valued over $100. UPS then restructured the insurance program so that the insurance was provided by an overseas affiliate, Overseas Partners, Ltd. ("OPL"). UPS purchased an insurance policy from National Union Fire Insurance Company ("National Union"), a third-party insurer, for National Union to assume the risk of damage or loss to shipments valued over $100. UPS paid National Union the excess-value charges collected from the customers as the premium for the policy. National Union and OPL then entered into a reinsurance contract where National Union paid to OPL the premiums (less fees and taxes) it had been paid by UPS. The court found there was real economic effect under this transaction because there was a real insurance policy created between National Union and UPS and the real risk that National Union assumed created a genuine insurance obligation enforceable by a third party.

[40] *ACM Partnership v. Commissioner*, 157 F.3d 231 (3d Cir. 1998), citing *Gregory v. Helvering*, 293 U.S. 465 (1935).

[41] Joint Committee on Taxation, Technical Explanation of the Revenue Provision of the "Reconciliation Act of 2010," as Amended, in combination with the "Patient Protection and Affordable Care Act" (JCX-18-10), p. 152 (March 21, 2010).

[42] *Id.*, at 152, n. 344.

changing the economic obligations of the parties to the insurance arrangement. The Service has stated that 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. [43] The Service has stated that risk-distributing entails a pooling of premiums, whereby a potential insured is not in significant part paying for its own risks which 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.[44] Courts have stated that by assuming numerous relatively small, independent risks that occur randomly over time, the insurer smoothes out losses to match more closely its receipt of premiums.[45]

III. Application of Law to the Company

For each of the Reinsurers to be considered an insurance company and taxable as such under the Code, the Direct Policies and the Reinsurance Agreements must constitute insurance contracts. In order to constitute insurance contracts, these agreements must constitute insurance in the commonly accepted sense, provide protection against insurance risks and include both risk-shifting and risk-distributing.

In order to meet the requirement of risk-shifting, the unrelated business insured by each Reinsurer must be more than fifty percent (50%) of its total business. Based on the Reinsurance Agreement, each Reinsurer's total coverage includes forty-nine percent (49%) of its own risk and fifty-one percent (51%) of the risk of unrelated parties. Additionally, the total premiums received by each Reinsurer are composed of forty-nine percent (49%) of its own premiums and fifty-one percent (51%) of the premiums from unrelated parties.

In order to ensure that adequate risk-distributing is present, there must be seven (7) or more Reinsurers. [46] For purposes of our opinion, we have assumed that the Pooling Arrangement always has and always will be composed of at least seven Reinsurers.

Based on these facts, the Direct Policies and Reinsurance Agreements should constitute insurance contracts.

In order for each Reinsurer to be respected as a separate entity for federal tax purposes, each Reinsurer must be formed for a valid business purpose. For purposes of our opinions, we

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[43] *See* Rev. Rul. 2002-89, 2002-2 CB 984; 2002-90, 2002-2 CB 985; 2002-91, 2002-2 CB 991; and 2008-8, 2008-5 IRB 340.

[44] Id.

[45] *Clougherty Packing Co. v. Comm'r*, 811 F.2d 1297, 1300 (9th Cir. 1987).

[46] *See* Rev. Rul. 2002-89 and Rev. Rul. 2002-91.

have assumed that each of the Company, Series A and each Reinsurer has been organized and is operating for bona fide business purposes.

Because (i) the Direct Policies and Reinsurance Agreements should constitute insurance contracts, (ii) the Company, Series A and each Reinsurer is assumed to have been formed for a valid business purpose and (iii) each Reinsurer is engaged only in the business of participating in insurance contracts, each Reinsurer should be considered an insurance company for federal tax purposes.

In order for a Series Member or a person related to such a Series Member to deduct the insurance payments, pursuant to Code Section 162, the transactions reflected in the Direct Policies and the Reinsurance Agreements must also have economic substance. Code Section 7701(o) provides a conjunctive requirement for economic substance – there must be an inquiry regarding the objective effects of the transaction on the taxpayer's economic position as well as an inquiry regarding the taxpayer's subjective motives, or purposes, for engaging in the transaction.

The Reinsurance Agreements and Direct Policies cause a permanent change in the obligations of each Series Member for the insured risks. As a result of the risk-shifting and risk-distributing in the Pooling Arrangement each Series Member receives premiums to insure a portion of the insured risks composed of forty-nine percent (49%) of Related Party Risks and fifty-one percent (51%) of Unrelated Party Risks. Because the assumption of the obligations pertaining to the Unrelated Party Risks is the majority of the risks assumed by a Series Member, and to which its assets are exposed, the Pooling Arrangement should create a meaningful change in the economic position of the Series Members.

Accordingly, for purposes of the economic substance requirement of Code Section 7701(o), the risk-shifting and risk-distributing accomplished by the Pooling Arrangement should change in a meaningful way (apart from federal income tax effects) the economic position of each Series Member participating in the Pooling Arrangement.

For purposes of our opinion we have assumed that each of Series A and the Reinsurers, by entering into the transactions reflected in the Direct Policies and Reinsurance Agreements, has a substantial purpose (apart from federal income tax effects) for entering into the transaction. Based on this assumption, the transactions represented by the Direct Policies and Reinsurance Agreements should have economic substance.

IV. General Conditions and Limitations

A. *Facts, Assumptions and Representations*

As to certain matters of fact, we have relied upon statements and representations of officers of the Company and statements and representations of the actuarial firm representing the Company which have not been independently established or verified by us. We have not

undertaken any investigation to confirm or verify any of the statements contained in the facts of this opinion. In rendering the opinions set forth above, we have assumed, without independent verification, among other things:

(i) Each natural person executing any document is legally competent to do so;

(ii) All signatures on any of the documents reviewed by us are genuine;

(iii) All documents submitted to us as originals are authentic, all documents submitted to us as certified or photostatic copies conform to the original document, and all public records reviewed are accurate and complete;

(iv) All unsigned forms of agreements reviewed by us are in all material respects the forms of documents executed in the creation of each Series; and

(v) The due authority on the part of, and due authorization, execution and delivery by, all parties of all documents in connection with the issuance of the documents required to be executed or delivered by or on behalf of such party.

We have also assumed that, except as described in this opinion, there are no other agreements or understandings between the parties to the documents that would affect the transactions to which this opinion applies. Any change in or addition to the facts and assumptions described in this opinion could materially and adversely affect our analysis and conclusions. If you believe any fact or assumption described in this opinion is inaccurate or incomplete, or if you are aware of any other facts or circumstances that may appropriately be taken into consideration in analyzing the transactions, you should immediately notify us in writing.

B. *Applicable Law*

The analysis and conclusions in this opinion relate solely to federal income tax consequences under the Code, and we have not addressed the tax consequences to you under any applicable state, local, or foreign tax law. References in this letter to "the tax law," "for federal tax purposes," "for federal income tax purposes," "for tax purposes," or the like, refer to the United States income tax laws as in effect with respect to the time or tax period with respect to which this opinion speaks. Our analysis and conclusions are based on the Code, the Treasury Regulations adopted or proposed under the Code, and certain case and ruling authority as of the date of this opinion. You should be aware that future changes in the Code or the Treasury Regulations, or the issuance of new case or ruling authority interpreting the

Code or the Treasury Regulations, could materially, and adversely affect our analysis and conclusions. The delivery of this opinion is not an undertaking on our part to advise you of any such changes or to update this opinion.

C. *Issues Addressed*

This opinion is limited to advice concerning the identified federal income tax issues as they relate to your federal income tax consequences arising from the transactions described in this opinion. This opinion considers only the identified federal income tax issues and does not consider all of the issues that may arise in connection with the transaction. We have not addressed the tax consequences attributable to any person or entity other than the Company. We express no opinion regarding the taxation of particular investments made by the Reinsurers or the effect of such investments on the opinions expressed herein.

D. *Disclaimer of Guarantee*

Our analysis and conclusions in this opinion are based upon our interpretation of the Code, the Treasury Regulations, and certain case and ruling authority as of the date of this opinion, and some matters upon which our analysis and conclusions are expressed are not free from doubt. Our analysis and conclusions are based upon our professional judgment, and should not be taken as a guarantee of the ultimate tax consequences of the transactions described herein. You should be aware that our analysis and conclusions are not binding on the Service, any state, local, or foreign tax authority, or on any court, and there can be no assurance that any of them will not adopt a position contrary to our analysis and conclusions.

E. *Potential for Litigation*

You should understand that if the Service or any other tax authority adopts a position contrary to the analysis and conclusions expressed in this opinion, it might be necessary for you to pursue administrative appeals or litigation concerning one or more issues addressed herein. We have assumed that in any litigation or administrative proceedings in which the issues addressed by this opinion are considered, the issues will be properly briefed and argued and that any decision rendered will be based on existing legal precedents. However, litigation and other adversarial proceedings are frequently decided based upon negotiation and pragmatism, including consideration of cost, publicity, and other matters unrelated to the technical merits regarding the tax consequences of a transaction. We have not considered the effect of negotiation or pragmatism upon the outcome of any potential litigation or proceedings.

F. *Limitation on Reliance and Distribution*

This opinion is being delivered to you at your request and solely for your use in connection with the Company and is a "limited scope opinion" as described in Circular 230 (31 C.F.R. Part 10) as promulgated by the Department of the Treasury to govern practice before the Service. Please note the disclosures in this regard at the top of this letter.

This opinion is rendered only for the benefit of the Company and no other person or entity may rely on the analysis and conclusions contained in this opinion without our written permission.

G. *Tax Assurance Standards*

The conclusions expressed in this opinion are based on our good faith belief that the tax treatment of the transactions described herein will be upheld by a court on the merits if the tax treatment of the transactions were to be challenged in litigation, and represents our professional judgment based upon our analysis of applicable law and the facts and assumptions described in this opinion.

Very truly yours,

NELSON MULLINS RILEY & SCARBOROUGH LLP

By
a Partner in the law firm

EKW/pbl

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