



Dear \_\_\_\_\_ :

This letter is in response to the ruling request filed on behalf of Reciprocal, dated December 28, 2004, and supplementary submissions. You request the Commissioner's consent to a revocation by Reciprocal of an election made under § 835(a) of the Internal Revenue Code (formerly § 826(e)) for the taxable year ending December 31, 2004.

Reciprocal represents that it writes medical professional liability insurance for physicians in State A and State B, and is wholly owned by its subscriber physicians. Reciprocal was incorporated in State A in Year 1. Since Reciprocal's inception in Year 1, AIF has been Reciprocal's exclusive manager. Effective for the Year 2 tax year, Reciprocal made an election under § 835 to be subject to the limitation provided in § 835(b). Reciprocal has continued to be subject to the provisions of § 835 pursuant to its election for all years from Year 2 up to and including \_\_\_\_\_. Reciprocal now seeks to revoke the election beginning with the taxable year ending December 31, \_\_\_\_\_.

Reciprocal represents that AIF fully manages the affairs of Reciprocal under the direction of Reciprocal's subscriber board of directors. That is, subject to the direction of Reciprocal's board, AIF sells and issues policies, investigates, settles, and defends claims, and otherwise manages Reciprocal's affairs. In consideration for performing these services, AIF receives a percentage based on Reciprocal's earned premium, as well as a portion of Reciprocal's profits. Reciprocal states that AIF pays salaries and personnel related expenses, rent and office operation costs, data processing costs and many other operating expenses of Reciprocal. Reciprocal represents that it pays all claims, claim expenses, peer review expenses, directors' fees and expenses, legal, actuarial and auditing expenses, its taxes, outside agent commissions and certain other specific expenses.

Reciprocal represents that AIF is a wholly-owned subsidiary of AIF Parent. AIF joins in the filing of a consolidated federal income tax return with AIF Parent and other eligible affiliates.

Pursuant to its election under § 835(a), Reciprocal reduces its deduction for amounts paid to the AIF by an amount equal to the excess of such amounts over the deductions of the AIF allocable to such income. Effectively, this election allows Reciprocal to replicate the tax determination of a consolidation of Reciprocal and AIF that would be otherwise unavailable due to Reciprocal's status as a mutual insurance company. Double taxation is avoided by § 835(d) which allows Reciprocal credit on its tax return for income taxes actually paid by AIF.

Because AIF computes its income taxes as part of a consolidated group, AIF's actual tax liability is affected by its affiliates' income and loss. When an AIF participates in a consolidated return, the tax credit allowed its Reciprocal bears the same relationship to the income tax paid by the AIF's consolidated group as the taxable income received by the AIF from the Reciprocal bears to the taxable income of the AIF's

consolidated group. The tax credit allowed to the Reciprocal, however, is limited to the total amount of tax paid by the AIF's consolidated group. Thus, if an AIF's consolidated tax return shows no tax due because of a net operating loss, the Reciprocal would not be allowed any credit. This is true even where AIF, standing alone, had income.

Even when a Reciprocal is not allowed a credit for taxes actually paid by the AIF, the Reciprocal is still required under § 835(b) to reduce its deduction for amounts paid to its AIF. In other words, a Reciprocal must still apply the provisions of § 835 unless and until the Commissioner consents to the revocation of Reciprocal's election to be treated under § 835.

Section 826 as originally enacted also allowed a Reciprocal to set aside a larger portion of income in the protection against loss account (PAL), by allowing the Reciprocal to take into its income the profit of its AIF on its management fee. Additions to the PAL account, however, were repealed in 1986. Reciprocal represents that it does not have any balance in the PAL account.

For taxable year Year 3, Reciprocal had taxable income of \$L. Reciprocal's taxable income for Year 3 included both income earned by Reciprocal, as well as income of \$M from AIF attributed to Reciprocal under § 835(b). Because AIF's parent paid no tax for Year 3, Reciprocal did not get a credit under § 835(d) to reduce its tax liability. Thus, Reciprocal paid additional taxes of \$N, which is 34% of the amount of \$M. For taxable year Year 4, Reciprocal estimates that it will include in its taxable income \$O from AIF attributable to Reciprocal under § 835(b). Reciprocal believes that AIF's parent will have no taxable income for Year 4, and, accordingly, Reciprocal will not get any tax credit pursuant to § 835(d). Consequently, Reciprocal asserts that its tax liability will be increased by \$P (34% of \$O) for Year 4. Reciprocal's tax liability due to its § 835 election for Year 3 and Year 4 is significantly greater than it would have been had Reciprocal not computed its taxes under that section. Such result was not intended for elections under § 835.

Section 1.826-1(d) of the Treasury Regulations provides that Reciprocal's § 835 election is binding for the taxable year for which made and all succeeding taxable years unless the Commissioner consents to a revocation of such election. Whether revocation will be permitted will depend upon the facts and circumstances of each particular case.

Consent is hereby granted to revoke the election made under § 835. The revocation is effective for Reciprocal's taxable year ending December 31, 2004. Reciprocal represents that it will not make an election under § 835 to be subject to the limitation provided in § 835(b) for any of the first five taxable years following the year to which this consent relates.

The ruling contained in this letter is based upon information and representations submitted by the taxpayer and accompanied by a penalty of perjury statement executed

by an appropriate party. While this office has not verified any of the material submitted in support of the request for rulings, it is subject to verification on examination.

This ruling is directed only to the taxpayer requesting it. Section 6110(k)(3) of the Code 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 your authorized representative.

A copy of this letter must be attached to any income tax return to which it is relevant.

Sincerely,

/S/

Donald J. Drees, Jr.  
Acting Chief, Branch 4  
Office of Associate Chief Counsel  
(Financial Institutions & Products)