Part I

Section 831.--Tax on Insurance Companies other than Life Insurance Companies

Rev. Rul. 2009-26

ISSUE

In the situations described below, is Z's agreement with IC Y treated as "reinsuring risks" underwritten by insurance companies for purposes of determining whether Z is an insurance company within the meaning of § 831(c)?

FACTS

Situation 1. IC Y and Z are stock corporations that are licensed and regulated as insurance companies in all jurisdictions in which they do business. IC Y is an insurance company for federal income tax purposes, subject to tax under § 831(a).

For valid, non-tax business purposes, IC Y entered into a contract, or treaty, with Z at the beginning of Year 1. Under the contract, IC Y agreed to pay to Z 90 percent of all the premiums received with regard to all the insurance contracts issued by IC Y in the commercial multiple peril line of business in a 10-state region. In exchange, Z agreed to indemnify IC Y for 90 percent of all the losses under those contracts. IC Y

remained directly liable to its policyholders. A contract of this type is sometimes referred to as indemnity reinsurance.

During Year 1, insurance contracts that IC Y entered into with 10,000 unrelated policyholders were subject to the contract between IC Y and Z. Z possessed adequate capital to fulfill its obligations under the contract, and in all respects operated at arms-length in its transaction with IC Y and in accordance with the applicable requirements of state law. The contract with IC Y was Z's only business during Year 1.

Situation 2. The facts are the same as in Situation 1, except that the contract between IC Y and Z covered only the risks of X, a policyholder of IC Y unrelated to Z. In addition, Z assumed risks of policyholders unrelated to X but in the same line of business through contracts with other insurance companies. The contracts with IC Y and with other insurance companies were Z's only business during Year 1. Had Z assumed these risks by entering into contracts with each of the original policyholders (including X) directly, those contracts would have qualified as insurance contracts for federal income tax purposes, and Z would have qualified as an insurance company for federal income tax purposes. See, e.g., Rev. Ruls. 2005-40, 2005-2 C.B. 4; 2002-91, 2002-2 C.B. 991; 2002-90, 2002-2 C.B. 985; and 2002-89, 2002-2 C.B. 984.

LAW

Section 831(a) of the Internal Revenue Code provides that taxes, computed as provided in § 11, are imposed for each taxable year on the taxable income of each insurance company other than a life insurance company. Section 831(c) provides that, for purposes of § 831, the term "insurance company" has the meaning given to such

term by § 816(a). Under § 816(a), the term "insurance company" means "any company more than half 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."

Neither the Code nor the regulations define the terms “insurance” or “insurance contract.” The Supreme Court of the United States 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). The risk transferred must be risk of economic loss. Allied Fidelity Corp. v. Commissioner, 572 F.2d 1190, 1193 (7th Cir. 1978). The risk must contemplate the fortuitous occurrence of a stated contingency, Commissioner v. Treganowan, 183 F.2d 288, 290-91 (2d Cir. 1950), and must not be merely an investment or business risk. Rev. Rul. 2007-47, 2007-2 C.B. 127. In addition, the arrangement must constitute insurance in the commonly accepted sense. See, e.g., Ocean Drilling & Exploration Co. v. U.S., 988 F.2d 1135, 1153 (Fed. Cir. 1993); AMERCO, Inc. v. Commissioner, 979 F.2d 162 (9th Cir. 1992).

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. 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).

Courts 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. Humana, Inc. v. Commissioner, 881 F.2d 247, 257 (6th Cir. 1989). See also Ocean Drilling & Exploration Co., 988 F.2d at 1153 ("Risk distribution involves spreading the risk of loss among policyholders."); Beech Aircraft Corp. v. U.S., 797 F.2d 920, 922 (10th Cir. 1986) ("'[R]isk distributing means that the party assuming the risk distributes his potential liability, in part, among others.") Thus, purported insurance arrangements that involve an issuer who contracts with only one policyholder do not qualify as insurance contracts for federal income tax purposes. Rev. Rul. 2005-40.

The Code and administrative guidance treat reinsurance in a manner similar to insurance for many purposes. For example, gross premiums of both life and non-life insurance companies include not only premiums on direct business, but also gross premiums in respect of assumed liabilities under contracts issued by another company. Section 803(b)(1)(E); Rev. Rul. 77-453, 1977-2 C.B. 236. Consistently, both life insurance reserves under § 807 and discounted unpaid losses under § 846 include not only reserves and losses on direct business, but also reserves and losses on liabilities assumed under contracts issued by another company. Furthermore, a contract that reinsures another contract is treated in the same manner as the reinsured contract under § 848(e)(5) for purposes of computing the amount of specified policy acquisition

expenses that must be capitalized and amortized as deferred acquisition costs (DAC) under § 848. Most importantly, both direct insurance and reinsurance business may qualify a taxpayer as an insurance company under § 816(a) or § 831(c), as applicable. But see § 845 (granting the Secretary explicit authority to reallocate, recharacterize, or make other adjustments with respect to certain reinsurance arrangements, but not referring to direct insurance).

Courts have generally analogized reinsurance to insurance, as well. For example, in Ocean Drilling & Exploration Co., 988 F.2d at 1153 n25, the court noted that "[d]irect insurance and reinsurance are both considered insurance," and in Cologne Life Reinsurance Co. v. Commissioner, 80 T.C. 859, 862 (1983), acq, 1985-2 C.B. viii, the court noted that "[u]nder [part I of subchapter L], the issuance of indemnity life reinsurance is treated generally as the issuance of life insurance", except where specified otherwise.

In Alinco Life Insurance Co. v. United States, 373 F.2d 336 (Ct.Cl. 1967), a large finance company formed a wholly-owed subsidiary corporation (Alinco), which qualified as a life insurance company under the laws of Indiana. Customers of the finance company (borrowers) purchased credit life insurance from an unrelated insurance company, which in turn reinsured a fixed proportion of those contracts with Alinco. Even though Alinco reinsured risks underwritten by only one insurance company, those risks aggregated nearly one billion dollars of business, with a large number of customers, for which Alinco was required by the state insurance department to maintain reserves. Interpreting regulatory language that was identical to what now appears in

§ 816(a), the court concluded that Alinco was in the business of "reinsuring risks" underwritten by insurance companies.

In the context of captive insurance, courts have likewise looked through a fronting arrangement to analyze whether the requirements of risk shifting and risk distribution were met. See, e.g., Carnation Co. v. Commissioner, 71 T.C. 400 (1978), aff'd 640 F.2d 1010 (9th Cir. 1981) (concluding that premiums paid by taxpayer to an unrelated insurer were not deductible to the extent risks under the contract were in turn reinsured with taxpayer's wholly-owned subsidiary); Kidde Industries, Inc. v. United States, 40 Fed. Cl. 42 (1997).

ANALYSIS

Situation 1

In Situation 1, the contracts issued by IC Y to 10,000 unrelated policyholders involved commercial multiple peril risks, which are insurance risks. The contracts shifted those insurance risks from those policyholders to IC Y, and distributed those risks such that a loss by one policyholder was not borne, in substantial part, by the premiums paid by that policyholder. The contracts were insurance in the commonly accepted sense. The contracts thus were insurance contracts for federal income tax purposes.

The contract, or treaty, between IC Y and Z in turn shifted 90 percent of the risks under those insurance contracts from IC Y, an insurance company, to Z. As in Alinco Life, the transaction shifted insurance risks which were funded by reserves and constituted reinsurance in the commonly accepted sense. As to Z, the risks of each

original policyholder were still distributed such that a loss by one such policyholder was not borne, in substantial part, by the premiums paid by that policyholder. Hence, by entering into its arrangement with IC Y, Z was "reinsuring risks" within the meaning of §§ 816(a) and 831(c).

Because, under the arrangement with IC Y, Z was treated as "reinsuring risks" underwritten by an insurance company, and the arrangement represented more than half the business of Z for Year 1, Z qualified as an insurance company within the meaning of § 831(c), even though the contract with IC Y was Z's only business for the year.

Situation 2

In Situation 2, the facts are the same as in Situation 1, except that the arrangement between IC Y and Z shifted to Z only the risks of X, a policyholder of IC Y unrelated to Z. Z assumed additional risks of the same line under contracts with other insurance companies in the same line of business.

The risks assumed by Z under the arrangements with IC Y and with other insurance companies were insurance risks. Those risks were shifted from the original policyholders (including X) to the primary insurers (including IC Y), and in turn to Z. As to Z, the risks of each original policyholder (including X) were distributed such that a loss by one policyholder was not borne, in substantial part, by the premiums paid by that policyholder. Hence, by entering into its arrangements with the primary insurers (including IC Y), Z was "reinsuring risks" underwritten by insurance companies within the meaning of §§ 816(a) and 831(c).

Because under the arrangements with the primary insurers (including IC Y) Z is treated as "reinsuring risks" underwritten by insurance companies, and those arrangements represented more than half the business of Z for Year 1, Z qualified as an insurance company within the meaning of § 831(c).

HOLDINGS

In Situation 1, Z's agreement with IC Y is treated as "reinsuring risks" underwritten by an insurance company because, even though the agreement was Z's only business during Year 1, the requirement of risk distribution was still met from the standpoint of Z as to each original policyholder. Accordingly, Z was an insurance company within the meaning of § 831(c).

In Situation 2, Z's agreement with IC Y is treated as" reinsuring risks" underwritten by insurance companies because, even though the agreement covered only the risks of a single policyholder, Z assumed sufficient risks under agreements with other insurance companies in Year 1 such that requirement of risk distribution was met from the standpoint of Z as to each original policyholder. Accordingly, Z was an insurance company within the meaning of § 831(c).

DRAFTING INFORMATION

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