

## Internal Revenue Service

Department of the Treasury

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Person to Contact:

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### Legend

Taxpayer =

A =

State A =

Federal Law =

State A Provisions =

State A Division =

Company C =

Committee =

Risk =

Organization Report =

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Date A =

Date B =

B Industry =

Subscribers =

Class A =

Class B =

Class C =

X =

Y =

Dear

This is in reply to your letter of Date A, in which you requested rulings as to the federal income tax consequences, under Subchapter L of the Internal Revenue Code of 1986, of the proposed transaction described below.

**FACTS**

Taxpayer will be formed on approximately Date B, as a reciprocal insurer under the insurance laws of State A to provide its Subscribers liability insurance for Risks. Taxpayer will be structured to qualify as a “risk retention group” within the meaning of

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State A Provisions and Federal Law. As a reciprocal risk retention group, Taxpayer will operate as a cooperative organization through which its Subscribers, acting through an attorney-in-fact, A, will exchange insurance contracts, thereby insuring each other.

Taxpayer will file the National Association of Insurance Commissioners (NAIC) approved annual statement blank for property and casualty insurance companies with the insurance department of State A.

The insurance contracts will be issued by Taxpayer and will provide Risk coverage. The contracts will be issued only to members of the B industry who are also Subscribers. The contracts will be occurrence contracts. The contracts will not provide for assessment of the Subscribers.

Each Subscriber will enter into a Subscriber's Agreement agreeing to 1) apply for subscribership in Taxpayer and for insurance coverage issued by Taxpayer; 2) appoint A as attorney-in-fact and authorize it, on behalf of the Subscriber, to exchange contracts of insurance and indemnity with the other Subscribers and to manage and conduct the business of Taxpayer; 3) agree to the role of the Committee as the governing body of Taxpayer and as representatives of the Subscribers and to be bound by its decisions; and 4) agree to be bound by and comply with all applicable provisions of the Rules and Regulations, the power of attorney, the Subscriber's agreement and the policy issued to it. Taxpayer represents that no Subscriber will be at risk for greater than X of Taxpayer's total risk exposure.

A Subscriber may terminate its Subscriber's agreement at the end of any policy year upon providing reasonable advance written notice to A. Upon termination, Subscriber's membership in Taxpayer terminates, all of Subscriber's outstanding insurance policies from Taxpayer are simultaneously cancelled and Subscriber's liability as an underwriter on policies issued by Taxpayer terminates with respect to claims occurring after the cancellation. Upon termination of a Subscriber's membership in Taxpayer, in accordance with Article XI of the Rules, Taxpayer is required to return the balance of the Subscriber Savings Account (SSA), subject to approval of the State A Division.

A is a State A business corporation. Taxpayer will own all the issued and outstanding shares of A's single class of common, voting stock. A will manage and administer Taxpayer's day-to-day insurance functions. A is responsible for establishing underwriting criteria; reviewing application; issuing policies; collecting premiums; administering, investigating, and paying claims; and paying taxes, fees, and other administrative expenses. A will be paid a quarterly fee for its services. Pursuant to its authority to contract with others, A will contract with Company C.

The Rules and Regulations (the Rules) will serve as the Taxpayer's corporate bylaws. The Rules provide that membership in Taxpayer becomes effective upon

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execution of a Subscriber's agreement and commitment by the Subscriber for payment of its first year's insurance premium. The Rules provide that membership will automatically terminate when the insurance coverage of the Subscriber is cancelled or terminated. Memberships are not transferable. The Rules provide for Class A, Class B and Class C Subscribers. Each Subscriber is entitled to vote, but is limited to no more than Y of the entire vote with respect to any one specific proposed resolution. The number of votes to which a Subscriber is entitled is set forth in the Rules.

The Rules provide that the Committee has general supervision and control over Taxpayer's property and affairs. The Committee appoints and has general supervision and control over the activities of A. Subscribers have the right to elect Committee at Taxpayer's annual meeting. The Committee has the authority, subject to approval by State A Division, to cause the Taxpayer to declare and pay dividends and make other distributions to the Subscribers. In the event of Taxpayer's liquidation or dissolution, any residual assets will be allocated among the Subscribers and distributed to them in accordance with a plan determined by Committee, approved by State A Division.

Article XI of the Rules, requires Taxpayer to maintain an unassigned surplus account, a paid-in surplus account for each Subscriber and a Subscriber Savings Account (SSA) for each Subscriber in Class A and Class B. Credits to SSAs will be made in accordance with standards and formulas adopted by the Committee and may be based on premiums paid, losses incurred, duration of insurance coverage, paid-in-surplus, and other relevant factors. Credits to SSAs will be made no later than March 15 following the calendar year to which the credits apply. Also, notifications must be mailed by this date to each eligible Subscriber setting forth the amount of the credit made to its SSA and the date the amount was credited. The Rules also provide that upon Subscriber's termination, the paid-in-surplus may be returned over a period of years. Taxpayer represents that with respect to the return of the balance of a SSA upon termination of the Subscriber's Agreement, if no event has occurred before termination that creates potential loss exposure to Taxpayer, it is expected that Taxpayer would return the remaining SSA, if any, within 60 days. However, if an event occurs before termination that creates potential loss exposure to Taxpayer, Taxpayer may defer return of the terminating Subscriber's SSA until the exposure to Taxpayer is substantially resolved by the issuance of the Organization Report. Once the exposure is substantially resolved by the issuance of such report, however, it is expected that Taxpayer would quantify the amount of the loss exposure, charge the Subscriber's SSA for its share of the loss, if any, and return the remaining SSA, if any, within 60 days after such resolution.

LAW

**Mutual insurance company as reciprocal:**

Section 7701(a)(3) of the Internal Revenue Code defines the term "corporation" to include insurance companies.

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Section 301.7701-1(c) of the Income Tax Regulations provides that for purposes of taxation the classification of an organization is determined under the Internal Revenue Code rather than under state law. The term “corporation” is not limited to the artificial entity usually known as a corporation, but also includes an insurance company.

Rev. Rul. 83-132, 1983-2 C.B. 270 holds that a noncorporate business entity that is primarily engaged in the business of issuing insurance contracts is an insurance company, and therefore a corporation within the meaning of section 7701(a)(3) of the Code, and thus is taxable as a corporation under the provisions of subchapter L.

Prior to 1987, mutual insurance companies were taxed under the provisions of §§ 821-825. The Tax Reform Act of 1986 repealed these provisions and mutual insurance companies are now taxed under §831 of the Code.

Section 831 of the Code provides that an insurance company other than a life insurance company is subject to tax at normal corporate rates on its insurance company taxable income.

Section 832 defines insurance company taxable income for purposes of the tax imposed by section 831 as the gross income of the insurance company as defined in section 832(b)(1), less the deductions allowed by section 832(c).

A distinguishing factor between a mutual insurer and a stock insurer is that the mutual insurer is controlled by and is operated for the benefit of policyholders. Neither the Code nor the regulations define mutual insurance company. The courts have determined that the characteristics of a mutual insurance company generally are 1) the right of policyholders to be members to the exclusion of others and the right of such members to choose the management; 2) the sole business purpose is to supply insurance substantially at cost; 3) the right of members to the return of premiums in excess of those amounts needed to cover losses and expenses; and 4) common equitable ownership of the assets by the members. See Rev. Rul. 74-196, 1974-1 C.B. 140.

Current section 832(f) is a redesignation of section 823(b)(2) which was originally enacted by the Revenue Act of 1962. Revenue Act of 1962, Pub. L. 87-834, section 8(c), 1962-3 C.B. 111, 140. In considering the provisions of the Revenue Act of 1962, the Senate Finance Committee described an interinsurer or reciprocal underwriter as:

Reciprocal underwriters and interinsurers differ from ordinary mutual insurance companies in that their business is conducted by two entities rather one. An ordinary mutual insurance company receives all of the premium income from insurance and not only pays losses but conducts directly the operation and management of the insurance activities. The reciprocal underwriter or interinsurer, on the other hand, pays its insurance losses, but an “attorney-in-fact” performs all, or most, of the

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insurance functions—writing policies, collecting premiums, settling claims, keeping records, etc.—and pays the related expenses, for a portion of the premium income of the reciprocal.

S. Rep. No. 1881, 87<sup>th</sup> Cong., 2d Sess. 54 (1962), 1962-3 C.B. 707, 763.

Taxpayer is an unincorporated association through which Subscribers, acting through A, will exchange insurance contracts, thereby insuring each other. Taxpayer's only business is providing Risk coverage substantially at cost. Subscriber membership terminates simultaneously upon termination of its insurance coverage. Subscribers, through their right to vote, select the management and elect members of Committee. Subscribers also have the right to receive policyholder dividends to the extent declared and paid by Taxpayer and have the right to share in the assets of Taxpayer upon liquidation. Taxpayer will pay the insurance losses and A will perform the insurance functions.

#### **Subscriber savings account (SSA):**

Section 832(f) provides that in computing the taxable income of an insurance company which is an interinsurer or reciprocal underwriter, the increase for the taxable year in savings credited to subscribers accounts is allowed as a deduction, and the decrease for the taxable year in savings credited to subscriber accounts is includable as a item of gross income.

Section 832(f) defines the terms "savings credited to subscribers accounts " as the portion of the surplus for the taxable year that is credited to the individual accounts of subscribers before the 16<sup>th</sup> day of the third month following the end of the taxable year, but only if the reciprocal would be obligated to pay this amount promptly to the subscriber if he terminated his contract at the close of the taxpayer's taxable year.

Section 832(f) was originally enacted as section 823(b)(2) by the Revenue Act of 1962. In 1986, this provision was redesignated section 832(f) as part of the consolidation of Parts II and III of subchapter L effected by the Tax Reform Act of 1986, Pub. L. 99-514, section 1024, 1986-3 C.B. (Vol. 1) 324. Because section 832(f) represents a redesignation of former section 823(b)(2), the provisions of the Income Tax Regulations issued with respect to prior section 823(b)(2) continue to provide guidance on the proper treatment of amounts credited to subscriber savings accounts for Federal income tax purposes.

#### **Deduction for the increase in SSA and an increase in income for the decrease in SSA:**

Section 1.823-(6)(c)(2)(i) of the regulations provides that with respect to interinsurers and reciprocal underwriters, a deduction is allowed for the increase for the taxable year in savings credited to subscriber accounts, or there is an inclusion as an

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item of gross income the decrease for the taxable year in savings credited to subscriber accounts.

Section 1.823-6(c)(2)(ii) provides that the deduction for savings credited to subscriber accounts may be claimed by a reciprocal only to the extent that the subscriber has a legally enforceable right to receive the amount credited to his account if he withdraws from the exchange, and where the amounts credited by the reciprocal to the individual accounts of its subscribers are actually paid to subscribers who terminate their insurance contracts during the taxable year. Thus, no deduction is allowed for savings credited to subscriber accounts if the savings are not in fact promptly returned to subscribers when they terminate their contracts.

Section 1.823-6(c)(2)(iii) provides that a reciprocal claiming a deduction under section 823(b)(2)(now section 832(f)) must establish and maintain an account for savings credited to subscriber accounts. The opening balance in such account for the first taxable year for which a deduction is claimed shall be zero and in each taxable year there shall be added to such account the total amount of savings credited to subscriber accounts for the taxable year (and there shall be subtracted from such account the total amount of savings subtracted from subscriber accounts for the taxable years). However, in no case may the amount added to the account exceed the total amount of "savings to subscribers for the taxable year", irrespective of the amount of savings credited to subscriber accounts by the reciprocal for that taxable year.

The regulations do not, however, define the term "savings to subscribers for the taxable year." According to the legislative history underlying section 823(b)(2), the special deduction for savings credited to subscribers accounts was intended to benefit "pure" or "classical" reciprocals which, as a matter of business practice, credited any savings from insurance operations to the individual accounts of their subscribers on a yearly basis and which were, in fact, obligated to pay these savings to a subscriber if the subscriber was to terminate his insurance contract and withdraw from the exchange at the end of such year. See H.R. Conf. Rep. 2518, 87<sup>th</sup> Cong. 2d Sess. (1962), 1962-3 C.B. 401, 453.

Accordingly, the term "savings to subscribers for the taxable year" as used in section 1.823-6(c)(2)(iii) means that the portion of the company's surplus credited to subscribers which is attributable to current operating income, rather than amounts included in surplus for which the source of the funds was the individual subscriber (such as subscriber contributions to join the reciprocal) or prior earnings. See also 1.823-6(c)(2)(ii) (amounts contractually required to be returned to policyholders due to policy cancellations or erroneously computed premiums are not "savings credited to subscribers" within the meaning of former section 823(b)(2)). Moreover, since the portion of surplus that a "pure" or "classical" reciprocal could properly allocate to its individual subscribers would be based on the company's statutory income rather than taxable income, the term "savings to subscribers for the taxable year" refers to the statutory income as reported on company's NAIC annual statement, including net underwriting gain or loss, net investment gain or loss, other income, dividends to

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policyholders, and federal and state taxes. For State A purposes, Generally Accepted Accounting Principles (GAAP) is used for statutory purposes.

Section 1.823-6(c)(2)(iii) provides that the increase, if any, in savings credited to subscriber accounts for the taxable year is generally the amount by which the balance in the account for savings credited to subscribers at the close of the current taxable year exceed the balance of such account at the close of the preceding taxable year; and the decrease, if any, for the taxable year in savings credited to subscriber is generally the amount by which the balance in the account for savings credited to subscriber accounts for the preceding taxable year exceed the balance of such account as of the close of the current taxable year.

Section 1.823-6(c)(2)(v) requires every reciprocal claiming a deduction under section 823(b)(2) (current section 832(f)) to mail to each subscriber written notification of the amount credited to his account for the taxable year, the date on which such amount was credited, and the date on which the subscriber's right to such amount first would be become fixed if such subscriber had terminated his contract at the close of the company's taxable year. This written notification must be mailed to every subscriber before the 16<sup>th</sup> day of the third month following the close of the reciprocal's taxable year.

The Committee will determine annually, by the March 15 following the calendar year to which the credits apply, the portion of the Taxpayer's income that will be credited to the Subscribers' SSAs and will notify the Subscribers by March 15 setting forth the amount of the credit made to the SSA and the date it was credited. The portion of Taxpayer's income credited to SSAs will not exceed Taxpayer's GAAP net income for the year. In the event of termination of a Subscriber's insurance contract, the balance in its SSA, will be paid promptly to the Subscriber. If an event occurs before termination that creates potential loss exposure to Taxpayer, payment may only be deferred until the exposure to Taxpayer is substantially resolved by the issuance of the Organization Report. Payment will be made within 60 days of issuance of the Organization Report.

**Savings credited to SSA treated as dividends paid or declared:**

Section 832(f) provides that the subscriber must treat the amounts representing savings credited to his account for a taxable year as a dividend paid or declared for purposes of computing the subscriber's taxable income.

Section 1.823-7 provides that a subscriber of a reciprocal underwriter or interinsurer entitled to the deduction allowed by section former section 832 (b)(2) and paragraph (c)(2) of section 1.823-6 shall treat amounts representing savings credit to its individual account for the taxable year as a dividend paid or declared for purposes of computing his taxable income.

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Section 1.823-7 further provides that to the extent the insurance premium constituted a deductible expense when paid or accrued, the subscriber's taxable income for the taxable year will be increased and any loss for the taxable year will be decreased, by the amount credited to his account.

**Deduction for policyholder dividends:**

Section 832(c)(11) provides a deduction for dividends and similar distributions paid or declared to policyholders, in their capacity as such, in computing the taxable income of an insurance company, other than a mutual fire insurance company, subject to tax under section 831. The term "paid or declared" is construed according to the method of accounting regularly employed in keeping the books of the insurance company.

Section 1.832-5(a) of the regulations allows a deduction for policyholder dividends under section 832(c)(11). This section further provides that the deduction is the same as that allowed under former section 822(c)(6) to mutual insurance companies subject to the tax imposed by (now repealed) section 821. (Now section 831).

According to section 1.822-12, the term "dividends to policyholders" means dividends and similar distributions paid or declared to policyholders in their capacity as such, and includes amounts returned to policyholders where the amount is not fixed in the insurance contract but depends upon the experience of the company or the discretion of the management. This regulation also provides that savings credited to the individual accounts of the subscribers of a reciprocal are not considered policyholder dividends paid or declared within the meaning of the former section 822(f)(2). However, this regulation provides that actual distributions made by a reciprocal with respect to its subscriber account balances are treated as policyholder dividends under former section 822(c)(6) for the year paid.

**Deductions for losses incurred:**

Section 832(b)(5) allows a deduction for losses incurred during the year on an insurance contract. Losses incurred are losses paid during the taxable year net of salvage and reinsurance recovered during the taxable year; plus all unpaid losses on life insurance contracts; and all discounted unpaid losses (as defined in section 846) outstanding at the end of the taxable year; minus all unpaid losses on life insurance contracts; and all discounted unpaid losses outstanding at the end of the preceding taxable year; plus estimated salvage and reinsurance recoverable as of the end of the preceding taxable year less estimated salvage and reinsurance recoverable as of the end of the taxable year.

**Absorption of losses:**

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Section 1.823-7 provides that amounts credited to a subscriber's account which are taken into income by him and which subsequently are used to absorb losses of the reciprocal shall be treated by the subscriber as an additional insurance expense for the taxable year in which the amounts are absorbed. Such amounts may be deducted in computing taxable income to the extent insurance constitutes an otherwise properly deductible expense for such taxable year.

Holdings:

Accordingly, based on the information submitted and representations made, it is held:

- 1) Taxpayer is a mutual insurance company that is an interinsurer or reciprocal underwriter within the meaning of § 832(f) of the Code.
- 2) Taxpayer is allowed a deduction for the increase for the taxable year in savings credited to the Subscriber Savings Accounts (SSAs).
- 3) Taxpayer will include as an item of gross income the decrease for the taxable year in savings credited to the SSAs.
- 4) Amounts representing savings credited to a SSA for the taxable year shall be treated by the Subscriber as a dividend paid or declared for purposes of computing its taxable income. To the extent the insurance premium paid by a Subscriber constituted a deductible expense when paid or accrued, the Subscriber's taxable income for the taxable year will be increased and any loss for the taxable year will be decreased by the amount credited to the SSA.
- 5) Taxpayer shall be allowed a deduction for policyholder dividends paid or declared to policyholders in their capacity as such.
- 6) Taxpayer shall be allowed deductions for losses incurred, as defined in § 832(b)(5).
- 7) Amounts credited to a SSA that were taken into income and which subsequently are used to absorb losses of Taxpayer constitute an additional deductible insurance expense for the Subscriber for the taxable year in which the amounts are absorbed. Losses for this purposes include the portion of GAAP losses credited to the SSA.

A copy of this ruling should be attached to Taxpayer's federal income tax return for the taxable year of the proposed transaction.

No opinion is expressed as to the tax treatment of the proposed transaction under any other provisions of the Code and regulations which may be applicable

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thereto, or the tax treatment of any effects resulting from the proposed transaction, which are not specifically set forth in this ruling letter.

This ruling letter is directed only to the taxpayer who requested it. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

Sincerely yours,

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(Financial Institutions & Products)