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Department of the Treasury
Washington, DC 20224

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Person To Contact:
, ID No.
Telephone Number:

Refer Reply To:
CC:FIP:B04
PLR-139415-06
Date:
December 14, 2006

Agreement =

Taxpayer =
Company 2 =
Year 1 =
Name X =
Date 2 =
Year 3 =
Date 4 =
Amount A =
Amount B =
Amount C =
Amount D =
Amount E =
TY =
Framework =

Dear

This is in response to your letter of August 16, 2006, as supplemented, requesting a ruling on the treatment under the Internal Revenue Code of Agreement between yourself ("Taxpayer") and Company 2.

FACTS

Taxpayer represents as follows:

Taxpayer is taxable under § 831 of the Code as a reinsurer of non-life insurance contracts. Previously, Taxpayer determined that its business interests would be served if it were able to buttress its surplus. Accordingly, on Date 2, Taxpayer entered into Agreement with Company 2. Company 2 is the parent corporation of Taxpayer. Company 2 is also a reinsurer of non-life insurance contracts.

Under Agreement, Taxpayer transferred to Company 2 on a 100% quota share basis the Taxpayer's liability for its net loss, including loss adjustment expenses, on insurance policies and reinsurance contracts issued by Taxpayer, including incurred but not reported losses, for losses occurring no later than Year 3, which was several years before Agreement. The covered lines of business included various environmental liabilities. Agreement terminates on Date 4, unless commuted earlier. As consideration, Taxpayer paid $ Amount A, which represented its statutory reserves for the transferred block of business.[1] Company 2 is obligated to pay any losses covered by Agreement to an aggregate limit of $ Amount C. Put another way, Company 2 is obligated to pay all losses covered by the Agreement from 'dollar one' up to the aggregate limit; Company 2's exposure in excess of the consideration paid by Taxpayer is $ Amount D.

The amount paid by Taxpayer was to be placed into a notional account which is to be reconciled quarterly and interest credited in the Amount E % per annum.[2] If prior to commutation or termination, the amount of claims exceeds the balance in the notional account, Company 2 must provide the funds, subject to the aggregate limit, necessary to pay the claims. A positive balance of the notional account upon termination is to be remitted to Company 2.[3]

The guidance for completing an insurance company's annual statement applicable to reinsurance transactions is Statutory Statement of Accounting Principles No. 62, *Property and Casualty Reinsurance* (SSAP 62). Applying SSAP 62, Agreement is to be considered a loss portfolio transfer accounted for as retroactive, not prospective, reinsurance. However, because Taxpayer and Company 2 have 100% common ownership, the "premiums" equal the loss reserves, and Agreement meets SSAP 62's criteria for risk transfer, SSAP 62 allows Taxpayer to instead account for Agreement as prospective reinsurance. The state insurance department that regulates Taxpayer has confirmed that this is the proper statutory accounting treatment for Agreement. There will be a discrepancy between the reserves shown on Taxpayer's annual statements (reflecting the accounting method for prospective reinsurance) and federal income tax returns (reflecting that the Agreement is not accounted for as reinsurance).

[1] Net of statutorily allowed discounting. The undiscounted amount of the ceded reserves is $ Amount B.
[2] This rate is significantly less than the rate applicable to the most analogous United States Treasury instrument.
[3] If Agreement is commuted prior to termination, Taxpayer and Company 2 are to negotiate a settlement amount. If no such amount is agreed to, Company 2 is entitled to a positive balance of the notional account.

No similar agreement was available in the commercial reinsurance market because, in part, of the Agreement's scope and that only Taxpayer and Company 2 could avail themselves of SSAP 62's exception from accounting for the Agreement as retroactive reinsurance.

On its federal income tax return for TY, Taxpayer reported Agreement under Framework.[4]

RULING REQUESTED

Taxpayer requests a ruling that Agreement does not constitute insurance for federal income tax purposes.

LAW AND ANALYSIS

Neither the Code nor the regulations thereunder define the terms "insurance" or "insurance contract." The bedrock for evaluating whether an arrangement constitutes insurance is Helvering v. Le Gierse, 312 U.S. 531, 539 (1941), in which the Court stated that "historically and commonly insurance involves risk - shifting and risk - distributing" in "a transaction which involve[s] an actual 'insurance risk' at the time the transaction was executed." Insurance has been described as "involv[ing] a contract, whereby, for adequate consideration, one party agrees to indemnify another against loss arising from certain specified contingencies or perils…[I]t is contractual security against possible anticipated loss." Epmeir v. United States, 199 F.2d 508, 509-10 (7th Cir. 1952). Cases analyzing "captive insurance" arrangements have distilled the concept of "insurance" for federal income tax purposes to three elements, applied consistently with principles of federal income taxation:[5] 1) involvement of an insurance risk; 2) shifting and distribution of that risk; and 3) insurance in its commonly accepted sense. See, e.g., AMERCO, Inc. v. Commissioner, 979 F.2d 162, 164-65 (9th Cir. 1992), aff'g 96 T.C. 18 (1991).

The risk transferred must be risk of economic loss. Allied Fidelity Corp. v. Commissioner, 572 F.2d 1190, 1193 (7th Cir.), cert. denied, 439 U.S. 835 (1978). The risk must contemplate the fortuitous occurrence of a stated contingency, Commissioner v. Treganowan, 183 F.2d 288, 290-91 (2d Cir.), cert. denied, 340 U.S. 853 (1950) and must not be merely an investment risk. Le Gierse, 312 U.S. at 542; Rev. Rul. 89-96, 1989-2 C.B. 114.

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[4] Taxpayer submitted its written inquiry seeking the letter ruling prior to the filing of returns or reports that are required by the revenue laws concerning Agreement. See § 2.01, Rev. Proc. 2006-1, 2006-1 I.R.B. 1, 6.

[5] These principles include respecting the separateness of corporate entities, the form and substance of the transaction(s), and the relationship between the parties. Sears, Roebuck and Co. v. Commissioner, 96 T.C. 61, 101-02 (1991), aff'd in part and rev'd in part, 972 F.2d 858 (7th Cir, 1992).

Insurance is not the mechanism to manage losses that are at least substantially certain to occur, i.e., that are not the result of fortuitous events.[6] This principle has various labels, and "embod[ies] the concept that one may not obtain insurance for a loss already in progress, or for a loss that the insured either knows of, planned, intended, or is aware is substantially certain to occur." 43 Am. Jur. 2d *Insurance*, § 479 (2005); see also COUCH ON INSURANCE 3d, § 102:8 (1997). Put another way, "[t]he fortuity principle is central to the notion of what constitutes insurance. The insurer will not and should not be asked to provide coverage for a loss that is reasonably certain or expected to occur within the policy period." 1 APPLEMAN ON INSURANCE 2d, § 1.4.

The "commonly accepted sense" of insurance derives from all of the facts surrounding each case, with emphasis on comparing the implementation of the arrangement with that of known insurance. Court opinions identify several nonexclusive factors bearing on this, such as the treatment of an arrangement under the applicable state law, AMERCO, Inc., 96 T.C. at 42; the adequacy of the insurer's capitalization and utilization of premiums priced at arm's length, The Harper Group v. Commissioner, 96 T.C. 45, 60 (1991), aff'd 979 F.2d 1341 (9th Cir. 1992); separately maintained funds to pay claims, Ocean Drilling & Exploration Co. v. United States, 24 Cl. Ct. 714, 728 (1991), aff'd per curiam, 988 F.2d 1135 (Fed. Cir. 1993); and the language of the operative agreements and the method of resolving claims, Kidde Indus. Inc. v. Commissioner, 40 Fed. Cl. 42, 51-52 (1997).

Rev. Rul. 89-96, 1989-2 C.B. 114, considered a circumstance in which Y "incurred a liability to injured persons the exact amount of which could not be ascertained, but was expected to be substantially in excess of $130x." Unfortunately, Y had insurance coverage with a limit of $30x; Y was vulnerable to claims in an indeterminable amount predicted to be substantially greater than an additional $100x. Y entered into an agreement with Z in an attempt to cover $100x of this shortfall; Z was fully aware of Y's circumstances. The "premium" charged Y was an amount that, together with the tax savings claimed by Z, was calculated to yield at least Z's maximum anticipated liability of $100x by the time claims were liquidated. The ruling concluded that the risk elements borne by Z were a timing risk (that the $100x would have to be paid out earlier than anticipated) and an investment risk (that the actual investment yield would be lower than forecast). The ruling concludes that these risks are not an insurance risk.

[6] One treatise notes that "[t]here are many contractual devices, legally valid, by which persons seek assurance and peace of mind regarding future events. These contracts of assurance have distinctive names, such as guaranty, warranty, suretyship, indorsement, pledge, mortgage, conditional sale, indemnity, and insurance. Collectively, they have a common purpose in protecting one against the harmful consequences of untoward future events. But it is frequently difficult to distinguish one from the other. Consequently, it is no facile matter to frame a definition which states accurately and plainly the common features of the enterprises that are generally regarded as subject to 'insurance' regulation." 1 APPLEMAN ON INSURANCE 2d, § 1.3.

The loss reserves of an insurance company other than a life insurance company are comprised of “case reserves” and “incurred-but-not-reported” (IBNR) reserves. Case reserves represent the estimate of the amount to be paid with regard to claims reported to company and IBNR reserves represent the estimate of the amount to be paid with regard to losses which were incurred but have not yet been reported to the company.

For federal tax purposes, losses incurred are the amount paid for losses on insurance contracts and the case reserves and IBNR reserves for amounts to be paid on losses that have been incurred on insurance contracts. E.g., §§ 832(b)(5)(A); 1.832-4(a)(14); of the Income Tax Regulations; 1.832-4(b). See also Sears, Roebuck and Co. v. Commissioner, 972 F.2d 858, 865 (7th Cir. 1992), aff’g in part, rev’g in part, 96 T.C. 61 (1991); Am. Int’l Group, Inc. v. United States, 38 Fed. Cl. 274, 282 (1997); State of Maryland Deposit Ins. Fund Corp. v. Commissioner, 88 T.C. 1050, 1059-60 (1987); Rev. Rul. 70-643, 1970-2 C.B. 141; § 2.04, Rev. Proc. 75-56, 1975-2 C.B. 596. Losses incurred represent the insurance company’s liability arising because the contingency(ies) stated in the insurance contract have occurred.

Here, the Agreement covers only Taxpayer’s loss reserves; that is, the element of fortuity is absent because the Agreement serves only to finance Taxpayer’s present obligation for incurred losses. Though the Agreement is unlike the situation in Rev. Rul. 89-96 because it is not predicated in part on projected tax savings, the Agreement is like the situation in Rev. Rul. 89-96 in that Company 2 has assumed only timing and investment risk (that the balance of the notional account, with interest credited at the specified rate, will not be sufficient to pay for the incurred losses).

In addition, Agreement is not insurance in the commonly accepted sense as envisioned by the caselaw. Taxpayer could not procure an arrangement with similar terms from the commercial reinsurance market because, among other things, the Agreement is practicable only between Taxpayer and Company 2.

Accordingly, the Agreement does not constitute insurance for federal income tax purposes.

Ruling

Based on Taxpayer’s representations, we rule that the Agreement does not constitute insurance for federal income tax purposes. Taxpayer should make any necessary reconciliation between the reserve amount shown on subsequent annual statements and the amount properly allowable under § 832(b)(5).

Except as expressly provided herein, no opinion is expressed or implied concerning the tax consequences of any aspect of any transaction or item discussed or referenced in this letter.

This ruling is directed only to Taxpayer. 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 Taxpayer's authorized representative.

A copy of this letter must be attached to any income tax return to which it is relevant. Alternatively, for a return(s) filed electronically this requirement is satisfied by attaching a statement to the return(s) that provides the date and control number of the letter ruling.

The rulings contained in this letter are based upon information and representations submitted by 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.

Sincerely,

Associate Chief Counsel
(Financial Institutions & Products)

/S/
By: __________________________
Donald J. Drees, Jr.
Acting Chief
Branch 4