Internal Revenue Service

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Date:
September 08, 2009

Legend:

Company =

State =

Date A =

Date B =

Number a =

Number b =

Number c =

Insurer =

Number d =

Number e =

Number f =

Reinsurer A =

Number g =

Reinsurer B =

Number h =

Number i =

Dear :

This is in response to the letter submitted on behalf of Company dated April 9, 2009, primarily requesting a ruling under section 831 relating to Company's status as an insurance company for federal income tax purposes. Specifically, the Company has requested rulings that (1) the reinsurance arrangement involving Company is insurance for federal income tax purposes, and (2) Company is an insurance company for federal income tax purposes.

FACTS

Company was incorporated in State on Date A. Company became licensed by State as a captive insurance company on Date B. All of the stock of Company is owned by a group of Number a individuals. These individuals also own Number b entities, which in turn own Number c franchises in a single industry.

Each of the Number b entities entered into two separate contracts with Insurer, an entity unrelated to Company, in an effort to secure insurance covering workers' compensation, general liability, property, automobile, and crime risks. For purposes of this letter ruling, it is assumed that Insurer is an insurance company as defined in section 816(a). One contract covers workers' compensation risks, while the other contract covers general liability, property, automobile, and crime risks. Pursuant to these contracts, Insurer would reimburse each of the entities up to a specified dollar amount for its losses associated with the types of risks set forth above in exchange for a premium. Company represents that Insurer performs the underwriting on all contracts issued to the Number b entities. Company represents that Number d other entities in the same industry entered into contracts that are identical in all material respects to the contracts entered into between Insurer and the Number b entities.

Insurer retains the exposure for all specified losses in excess of Number e dollars (up to limits specified in each contract) per occurrence for all risks except losses related to crime. For crime risks, Insurer retains exposure for all specified losses in excess of Number f dollars (up to a stated maximum amount set forth in the contract). The remaining risks for all types of coverage covered by the policies issued by Insurer to the Number b entities as well as the Number d entities are ceded by Insurer to Reinsurer A. Reinsurer A, which is unrelated to Company, is assumed for purposes of this letter ruling to be an insurance company as defined in section 816(a).

Reinsurer A retains the first Number g dollars of risk exposure for all risks covered by the contracts issued by Insurer to each of the Number b entities as well as the Number d entities. Through a retrocession agreement, Reinsurer A cedes Number f dollars in excess of the first Number g dollars to Reinsurer B.

Reinsurer B is a foreign segregated cell insurance company that provides quota share reinsurance to Company and Number h other entities unrelated to Company covering the entire layer of risks ceded by Reinsurer A. In exchange for a portion of the overall premium pursuant to the quota share reinsurance arrangement, Company reimburses Reinsurer B for a proportional share of its losses that are covered by the contracts underwritten by Insurer. For purposes of this ruling, it is assumed that Reinsurer B is an insurance company as defined in section 816(a).

Company has represented that its sole business is the reinsuring of risks pursuant to the quota share agreement. Company further represents that it complies with the minimum capital and surplus requirements mandated by the laws of State, files annual statements with the insurance regulatory agency of State, and complies with State's requirements for filing premium tax returns. In addition, Company represents that none of its owners guarantee its performance under the quota share reinsurance arrangement.

LAW AND ANALYSIS

Requested Ruling #1

Neither the Code nor the regulations define the terms "insurance" or "insurance contract" in the context of property and casualty insurance. 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. LeGierse, 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. United States, 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 as claim. 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. 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 and Exploration Co., 988 F.2d at 1153 ("Risk distribution involves spreading the risk of loss among policyholders."); Beech Aircraft Corp. v. United States, 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.")

The "commonly accepted sense" of insurance derives from all the facts surrounding each case, with emphasis on comparing the implementation of the arrangement with that known to be insurance. Court opinions identify several nonexclusive factors bearing on this, such as the treatment of an arrangement under the applicable state law, AMERCO, 96 T.C. at 41; 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, 55 (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, 49 Fed. Cl. 42, 51-52 (1997).

In the present situation, there is risk shifting and risk distribution. Risk of loss for various property and casualty risks faced by the Number b entities and the Number d entities was shifted to Insurer when each entered into the contracts with Insurer. Pursuant to these contracts, Insurer would reimburse each of the entities up to a specified dollar amount for its losses associated with the types of risks set forth above in exchange for a premium. Thus, each of the Number b entities' and the Number d entities' risk of loss was shifted to Insurer.

Moreover, there is risk distribution in the arrangement described above. There are multiple insureds, none of whom control Company and Company provides those insureds with coverage. The insureds are in the same industry and each has been issued policy forms that are identical in all material respects. In addition, there are a sufficient number of unrelated insureds such that no one insured is paying for a significant portion of its own risks. Thus, a sufficient level of risk distribution of homogenous risks has been achieved through this arrangement.

As stated above, Company is solely in the business of reinsuring of risks pursuant to the quota share reinsurance arrangement. Reinsurance is commonly thought of as a contract whereby one insurer transfers or 'cedes' to another insurer all or part of the risk

it has assumed under a separate or distinct policy or group of policies in exchange for a portion of the premium. In essence, reinsurance is insurance for insurance companies. COUCH ON INSURANCE § 9:1 (2008). And this view of reinsurance has been shared in the context of litigation concerning federal income taxes. See, e.g., Colonial Am. Life Ins. Co. v. Commissioner, 491 U.S. 244, 246-47 (1989).

Here, the quota share arrangement between Reinsurer B and Company has all the hallmarks of reinsurance. As such, the arrangement between Company and Reinsurer B constitutes insurance for federal income tax purposes.

Requested Ruling #2

Section 831(a) of the Internal Revenue Code provides that taxes, computed as provided in section 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 section 831, the term "insurance company" has the meaning given to such term by section 816(a). Under section 816(a), the term "insurance company" means "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."

As stated above, it is assumed for purposes of this letter ruling that Insurer, Reinsurer A, and Reinsurer B are insurance companies as defined in section 816(a). Furthermore, Company has represented that its sole business is the reinsuring of risks pursuant to the quota share arrangement with Reinsurer B. Therefore, because Company's only business is the reinsuring of risks underwritten by insurance companies, it is an insurance company for federal income tax purposes.

CONCLUSION

Based solely on the information submitted and the representations made, we conclude that the arrangement between Company and Reinsurer B is insurance for federal income tax purposes. In addition, based on the information submitted and the representations made, and based on the assumptions that Insurer, Reinsurer A, and Reinsurer B are insurance companies within the meaning of section 816(a), we conclude that Company is in the business of reinsuring risks underwritten by insurance companies and will be treated as an insurance company taxable under section 831.

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. Specifically, no opinion has been requested and none has been expressed as to whether Insurer, Reinsurer A, and Reinsurer B are insurance companies within the meaning of section 816(a). Furthermore, no opinion has been requested and none has been expressed as to whether Reinsurer B is an entity for federal income tax purposes.

The rulings contained in this letter are 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.

A copy of this letter must be attached to any income tax return to which it is relevant. Alternatively, taxpayers filing their returns electronically may satisfy this requirement by attaching a statement to their return that provides the date and control number of the letter ruling.

In accordance with the Power of Attorney on file with this office, a copy of this letter is being sent to your authorized representative.

Sincerely,

/S/

Donald J. Drees, Jr.
Senior Technician Reviewer, Branch 4
(Financial Institutions & Products)