MORRISON | FOERSTER

Legal Updates & News

Legal Updates

IRS Confirms the Application of a "Look-Through" Rule in Determining Whether the Risk Distribution Requirement is Satisfied for Reinsurance Companies

September 2009
by Robert A. N. Cudd, Michelle Jewett, Karen Guo

Related Practices:

- Federal Tax
- Tax

In Revenue Ruling 2009-26 (the "Ruling"), issued on September 1, 2010, the IRS provided guidance on whether a reinsurance contract between a corporation (a "Reinsurer") and an insurance company is treated as "reinsuring risks" underwritten by insurance companies for purposes of determining whether the Reinsurer is an insurance company under Section 831(c) of the Internal Revenue Code of 1986, as amended (the "Code"). Applying a look-through rule for determining risk distribution, the IRS determined that the Reinsurer was an "insurance company" in each of two distinct fact patterns, one of which involved a Reinsurer reinsuring a single block of insurance contracts issued to different policy holders and insured by a single insurance company unrelated to the Reinsurer, and the other of which involved a Reinsurer reinsuring multiple blocks of contracts, with at least one of the blocks containing contracts issued to only one policy holder unrelated to the Reinsurer.

The Ruling confirms, as tax practitioners have long believed to be the case, that in determining the risk distribution of a Reinsurer with respect to a particular insured, all similar classes of risks insured by the insurer should be considered, irrespective of whether such risks were insured by the same insurer which had provided the original policy to the particular insured.

Background

A non-life insurance company is an "insurance company" for U.S. federal income tax purposes if more than half of its business during the tax year consists of the issuing of insurance or annuity contracts or the reinsuring of risks underwritten by insurance companies.[1] Neither the Code nor Treasury Regulations define the terms "insurance" or "insurance contract." However, the U.S. Supreme Court has said that both risk shifting and risk distribution must be present for an arrangement to be treated as insurance.[2]

For this purpose, 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, so that an actual loss will not affect the insured because the loss is offset, at least in part, by the insurance payment. Risk distribution occurs when the party assuming the risk distributes its potential liability among others, at least in part. Risk distribution spreads the cost of a potential loss throughout a group, and necessarily entails a pooling of premiums, so that a potential insured is not in significant part paying for its own risks.

The Ruling confirms that the IRS will follow a number of court decisions to treat a reinsurance company as if it were insuring the risks of the underlying direct insureds in measuring risk distribution. Had the Reinsurer only reinsured one policy with a single insured, however, it seems clear that the risk distribution requirement would not have been satisfied.

The Ruling

In the Ruling, the IRS analyzed two situations to determine whether, by entering into an agreement with an insurance company subject to tax under Code Section 831(a) ("Y"), a Reinsurer ("Z") was to be treated as reinsuring risks underwritten by insurance companies for purposes of determining whether Z was an insurance company under Code Section 831(c).

Situation 1
For valid, non-tax business purposes, Y entered into a contract with Z at the beginning of Year 1, under which Y agreed to pay to Z 90% of all the premiums received from all the insurance contracts Y issued. In exchange, Z agreed to indemnify Y for 90% of all the losses under those contracts. Y remained directly liable to its policy holders. During Year 1, insurance contracts that Y entered into with 10,000 unrelated policy holders were subject to the contract between Y and Z. The contract with Y was Z's only business during Year 1.

The Ruling concluded that Z's agreement with Y was 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 met from the standpoint of Z as to each original policy holder since a loss by one policy holder was not borne in substantial part by the premiums paid by that policy holder. Moreover, the reinsurance contract then shifted the risk from Y to Z. The IRS ruled that, accordingly, because Z was treated as reinsuring risks underwritten by an insurance company and the contract represented more than half of Z's business, Z qualified as an insurance company under Code Section 831(c).

Situation 2
The facts are the same as in Situation 1, except that the contract between Y and Z covered only the risks of X, a policy holder of Y unrelated to Z. In addition, Z assumed risks of policy holders unrelated to X but in the same line of business through contracts with other insurance companies. The contracts with Y and with other insurance companies were Z's only business during Year 1.

The Ruling concluded that Z's agreement with Y was treated as reinsuring risks underwritten by insurance companies because, even though the agreement covered only the risks of a single policy holder, Z assumed sufficient risks under agreements with other insurance companies in Year 1 such that the requirement of risk distribution was met from the standpoint of Z as to each original policy holder. The risks assumed by Z under the arrangements with Y and with other insurance companies were shifted from the original policy holders (including X) to the primary insurers (including Y), and in turn to Z. Accordingly, because under the arrangements with the primary insurers, Z was 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 under Code Section 831(c).

* * * * *

To ensure compliance with requirements imposed by the IRS, Morrison & Foerster LLP informs you that, if any advice concerning one or more U.S. federal tax issues is contained in this communication, such advice is not intended or written to be used, and cannot be used, for the purpose of (i) avoiding penalties under the Internal Revenue Code or (ii) promoting, marketing, or recommending to another party any transaction or matter addressed herein.

Footnotes

[1] I.R.C. §§ 831(c), 816(a).

[2] *Helvering v. LeGierse*, 312 U.S. 531 (S. Ct. 1941).
