Is Homogeneity Required to Qualify as Insurance?

by Peter H. Winslow, Susan J. Hotine and Gregory K. Oyler

Since the income tax was enacted, the IRS and tax practitioners have struggled with the fundamental question: what is insurance? The term is not defined in the Internal Revenue Code except indirectly in I.R.C. § 7702 which defines a life insurance contract. Instead, Congress has deferred to the courts to develop the criteria to determine whether an arrangement will be treated as insurance for tax purposes.

In the context of captive insurance companies, the Tax Court has developed a three-pronged framework for a facts-and-circumstances analysis in determining whether an arrangement is insurance for tax purposes: (1) an insurance transaction must involve "insurance risk"; (2) "insurance" is to be defined in its commonly accepted sense; and (3) insurance involves risk shifting and risk distribution.[1] The courts have characterized the elements of this framework not as independent or exclusive, but as informing each other and, to the extent not fully consistent, confining each other's potential excesses.

Under the Tax Court's test, the existence of "insurance risk" is a threshold requirement in determining whether insurance exists for tax purposes. Generally, insurance risk is present if an insured faces some hazard, and an insurer accepts a premium and agrees to perform some act if or when the loss event relating to the hazard occurs.[2] The focus is on the nature of the losses covered by the policies and the designated responsibility for payment of those losses. In general, this part of the test probably will be met if: (1) the types of risk insured are risks for which commercial insurance companies typically issue insurance policies; and (2) the terms of the policy do not convert the coverage to a mere investment risk, a loan, a mere claims-servicing arrangement, or some other arrangement that does not involve insurance risk.

The second factor in the Tax Court's test is that insurance arrangements must comport with commonly accepted notions of insurance to be treated as insurance. Significant factors in this determination include whether: (a) the insurer is organized and operated as an insurance company; (b) the insurer is regulated under insurance law; (c) the insurer is adequately capitalized; (d) premiums are negotiated at arm's length; and (e) policies issued by the company are valid and binding.[3]

The third factor is that an insurance transaction generally must involve risk shifting and risk distribution to be treated as insurance for tax purposes.[4] Under the case law, the risk shifting inquiry requires an examination on one level of the terms of the policy to determine whether it transfers an insurance risk from the insured to the insurer. Further, there must be an examination on a second level whether, under the economic and other conditions outside the policy, the true burden of economic loss has been shifted to the insurer in the event of adverse claims.[5]

Whether an arrangement transfers risk for book purposes probably is an important aspect of the test, although it is doubtful whether the IRS would consider it deter-

Peter H. Winslow is a partner with the Washington, D.C. law firm of Scribner, Hall & Thompson, LLP and may be reached at *pwinslow@scribnerhall.com.*

Susan J. Hotine is a partner with the Washington, D.C. law firm of Scribner, Hall & Thompson, LLP and may be reached at *shotine@scribnerhall.com.*

Gregory K. Oyler is a partner with the Washington, D.C. law firm of Scribner, Hall & Thompson, LLP and may be reached at *goyler@scribnerhall.com.*

[1] *See AMERCO v. Commissioner,* 96 T.C. 18 (1991), *aff'd,* 979 F.2d 162 (9th Cir. 1992); *Harper Group v. Commissioner,* 96 T.C. 45 (1991), *aff'd,* 979 F.2d 1341 (9th Cir. 1992); *Sears, Roebuck and Co. v. Commissioner,* 96 T.C. 61 (1991), *aff'd in part and rev'd in part,* 972 F.2d 858 (7th Cir. 1992).

[2] *See AMERCO,* 96 T.C. at 38-39.

[3] *See Harper,* 96 T.C. at 60.

[4] *Helvering v. Le Gierse,* 312 U.S. 531, 539 (1941).

[5] See the related discussion in *Taxing Times* Tidbits "IRS Rules that Retroactive Reinsurance Is Not Reinsurance for Tax Purposes."

minative for tax purposes.[6] The applicable financial accounting standards for determining whether risk is transferred from an insurer to a reinsurer can be found in *Statement of Financial Accounting Standards No. 113* (FAS 113), paragraphs 9, 11, and *Statement of Statutory Accounting Principle No.* 62 (SSAP 62). Under FAS 113, for a policy to qualify for reinsurance accounting treatment, it must transfer insurance risk from an insurer to a reinsurer. To satisfy this requirement, (i) the reinsurer must assume significant insurance risk with respect to the underlying contracts so that it is *reasonably possible* that the reinsurer may realize a *significant loss* from the transaction, or (ii) it must be evident that the reinsurer has assumed substantially all of the insurance risk with respect to the underlying insurance contracts. As a rule of thumb, the reasonable-risk-of-significant-loss standard generally has been understood to require at least a 10-percent chance of a 10-percent loss ("10-10 Test"). This is usually interpreted to mean that the *underwriting loss* at the 90th percentile must be at least 10-percent of the ceded reinsurance premiums (*i.e.,* the ultimate incurred loss is expected to be 110 percent of premiums), where both underwriting loss and premiums are stated as present values.[7]

Under FAS 113, for a policy to qualify for reinsurance accounting treatment, it must transfer insurance risk from an insurer to a reinsurer.

Insurance arrangements also must involve risk distribution to be treated as insurance for tax purposes. The Tax Court has described risk distribution as follows:

> Under principles of the insurance industry, risk transfer and risk distribution occur only when there are sufficient unrelated risks in the pool for the law of large numbers to operate. As the number of unrelated risks is increased, protection is improved against the chance that the severity and number of harmful events will be spread over time or in other ways in groupings disproportionate to the overall risk. *That is, with an increasing number of ventures in a combined pool, the unusually favorable and unusually harmful experiences tend to stay more nearly in balance.* * * *[8]

Factors that the IRS generally examine to determine whether risk distribution is adequate typically relate to the number of insureds, the existence of unrelated insureds, concentrations of insureds, concentrations of risks, and, recently, the homogeneity of risks. In the context of captive insurance companies covering only brother-sister affiliated company risks, cases finding adequate risk distribution have generally involved large numbers of insureds.[9] On the other hand, risk distribution has been found generally adequate in cases involving a large number of *unrelated* insureds.[10]

There also has been some guidance from the IRS on this issue. In Rev. Rul. 2002-90, 2002-2 C.B. 985, the IRS ruled that amounts paid for professional liability coverage by 12 operating subsidiaries to an insurance subsidiary of the common parent were deductible as "insurance premiums" under I.R.C. § 162. The IRS concluded risk distribution was adequate where together the 12 subsidiaries had a significant volume of independent,

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[6] *See* FSA 200209017 (Nov. 26, 2001).

[7] In August 2005, the Casualty Actuarial Society published a paper that proposed an "Expected Reinsured Deficit" as an alternative to the 10-10 Test. A working group of the American Academy of Actuaries followed suit with a report that agreed that there could be other acceptable risk transfer tests other than the 10-10 Test. The Canadian Institute of Actuaries also has formed a task force that is expected to issue a paper that will consider risk transfer and related issues.

[8] *Gulf Oil Corp. v. Commissioner,* 89 T.C. 1010, 1025-1026 (1987) (fn. ref. omitted), quoting from R. Keeton, Insurance Law Basic Text 6-7 (1971) (emphasis in original).

[9] *See, e.g., Kidde Industries, Inc. v. U.S.*, 40 Fed. Cl. 42 (1997) (risk distribution where workers' compensation, automobile, and general liability risks of over 100 subsidiaries were involved); *Humana, Inc. v. Commissioner,* 881 F.2d 247 (6th Cir. 1989) (risk distribution where risks of several dozen subsidiaries operated even more hospitals); *Harper, supra* (30 percent of premiums attributable to 2500 insureds provided sufficient pooling for risk distribution).

[10] *See, e.g., AMERCO, supra,* (unrelated insurance of over 50 percent of insurer's business provides adequate risk distribution, given diverse and multifaceted character of risks); *Harper, supra,* (unrelated insureds comprising 30 percent constitute sufficient pooling for risk distribution); *but cf. Gulf Oil, supra* (no risk distribution where less than 2 percent of a captive insurance company's business comes from unrelated insureds).

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homogeneous risks, and no subsidiary had less than five percent or more than 15 percent of the total risk insured by the captive. The captive retained all the risk that it insured from the subsidiaries. Other factors present in the ruling included a valid non-tax business purpose, adequate capital with no parental or related-party guarantees, a captive that was fully licensed in the state of its formation and the other states in which it conducted business, arm's-length premiums established according to customary industry rating formulas, and no loans by the captive to the parent or its sister operating subsidiaries.[11] In FSA 200202002 (Sept. 28, 2001), the IRS concluded that risk distribution was unlikely where insurance arrangements involved the risks of only two sister companies, with one company accounting for 86- to 88-percent of the captive's premium income and the vast majority of the risks covered.[12]

Although homogeneity of risks is not often mentioned by the cases as supportive of risk distribution, it seems to be an important factor for the IRS. In Notice 2005-49, the IRS requested comments on the factors to consider in the definition of insurance and asked for comments regarding "the relevance of homogeneity in determining whether risks are adequately distributed for an arrangement to qualify as insurance."[13] The importance of homogeneity is unclear, however. Where a larger group of risks is similar, the law of large numbers may operate to reduce the risk that multiple claims will deplete the company's capital. In this sense, homogeneity can be said to enhance risk distribution. On the other hand, a concentration of similar risks could have the opposite effect making diversification of risk desirable. For example, a combination of an adequate pool of one type of risk (*e.g.*, workers' compensation) with an adequate pool of another risk (*e.g.*, property) can provide more risk distribution than a larger, separate pool of either type of risk alone.

On April 13 and June 5, 2007, the IRS released PLR 200715012 (Jan. 11, 2007) and PLR 200724036 (March 20, 2007), each of which concludes that the I.R.C. § 501(c)(15) tax exemption for small nonlife insurance companies does not apply because the contracts issued by the taxpayer in question were not insurance. The rulings specifically include discussions of homogeneity of risks as being relevant to the determination of whether the contracts issued by the company provide sufficient risk distribution to qualify as insurance for tax purposes.

For the risk distribution discussion, PLR 200715012 focuses on the fact that the company issued 14 insurance contracts in one year, and those same contracts plus two reinsurance contracts covering four contracts in another year. Although the insureds and ceding company were all unrelated to the owner of the insurance company, each of the insureds was an individual member of the same family, or was a corporation owned by the same family. This also was true for the ultimate insureds in the reinsured contracts. For the directly issued contracts, five types of insurance contracts were issued—personal disability coverage (eight contracts), corporate general liability coverage (one contract), corporate business owner's coverage (two contracts), personal property coverage (two contracts) and corporate directors and officers coverage (one contract). The ruling concludes that these facts do not result in insurance because "[t]here is no statistical phenomenon known as the 'law of large numbers' among each different type of insurance. There is no risk distribution of any of the five policies to help cover any claims that could be filed."

To reach its conclusions in PLR 200715012, the IRS might have relied solely on its alternative analysis that investment activities, rather than insurance activities, predominated. Instead, the IRS provides the analysis that "[i]f we consider each individual type of policy separate, because they are not homogeneous, it is the Service's position that there is not adequate risk distribution." However, the IRS cites no authority for its apparent conclusion that the application of the law of large numbers requires homogeneous risks. Although there seemed to be adequate risk shifting, the IRS said that, without adequate risk distribution, the contracts did not qualify as insurance. The IRS' position as stated introduces a new element—whether the risks are homogeneous—to be considered in determining "what is insurance" for tax purposes.

PLR 200724036 involved an insurance company that was created to provide medical malpractice insurance. In

[11] *See also* Rev. Rul. 2005-40, 2005-2 C.B. 4, Situation 2 (risk distribution not achieved where one insured with significant independent, homogeneous risks provided 90 percent of the total amounts earned and 90 percent of total risks assumed by the unrelated insurer); Rev. Rul. 2002-89, 2002-2 C.B. 984, (risks from unrelated parties representing 10 percent of total risks borne by subsidiary insufficient to qualify arrangement between parent and subsidiary as insurance).

[12] *See also* TAM 200323026 (Feb. 7, 2003) (limited risk distribution found where two-thirds of premiums covered pollution risk at a few locations of one insured and remaining third covered relatively small number of operations of five insureds).

[13] *See also* Rev. Rul. 2005-40, *supra*.

2005, the company issued six insurance contracts: two policies providing medical malpractice coverage for the company's owner and her husband, one policy providing various commercial coverages for a local coroner, and three policies providing commercial flood insurance coverage for the owner's and husband's businesses, and for an unidentified company. The IRS concluded that there were too few risks to satisfy the risk distribution requirement, noting also that the lack of homogenous risks "further diluted the distribution within the small number of insureds." The IRS went on to describe risk distribution in terms of the availability of capital to pay claims. The ruling concludes that the company's risks were spread over too many different lines of high-risk coverage increasing the likelihood that a single costly claim would exceed the company's ability to pay the claim.

With PLR 200715012 and PLR 200724036 the IRS already might have answered, at least in part, the question raised by its request for comments in Notice 2005-49: under what circumstances should the IRS rule that insurance of unique risks does not qualify as insurance because there are no similar risks being insured? According to the rulings, the lack of homogeneity of risks can be an important factor in concluding that risk distribution is not present. However, the rulings do not attempt to address the more fundamental questions of what are homogeneous risks and when will this factor govern the outcome. It appears that the answer lies in an analysis of whether the principle of the "law of large numbers" has come into play. Similarity of risks should not be an absolute requirement under the IRS' test, however, if an insurance company were to insure a large number of disparate risks and the company's capital is sufficient to pay claims as they occur. Unfortunately, the rulings provide little guidance as to where the line will be drawn so that the law of large numbers will be considered to apply to insurance of unique risks.

Editor's Note: Can any readers shine some light on this question? Is there actuarial literature that addresses the relationship between homogeneity and level of risk? *Taxing Times* would like to hear from you on this question.

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