Office of Chief Counsel
Internal Revenue Service
Memorandum

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to: Revenue Agent

from: Joseph F. Long
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(Large & Mid-Size Business)
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subject:

This is in response to your request for our advice on whether this transaction is controlled by Rev. Rul 89-96. This document should not be used or cited as precedent.

LEGEND:

A Company =

B Company =

E Company =

year 1 =

year 2 =

year 3 =

year 4 =

aaaa - bbbb =

X% =

Dollar Amounts =

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FACTS:

The adjustment proposed by the Large and Mid-Sized Business team (Service) concerns whether B Company (the assuming company) is subject to insurance risk with respect to a reinsurance contract entered into with A Company (the ceding compay/cedent). The Service has provided this office with its write up of the facts and law as well as its computations and spreadsheets.

B Company treated the transaction as retroactive reinsurance on its Annual Statement for year 1 through year 4. For tax purposes, the contract was booked as an insurance transaction so the unpaid loss reserve was discounted under I.R.C. § 846.

In year 1, A Company and B Company entered into a retroactive reinsurance contract. Coverage under the contract begins on 12/31/year 1. This contract cedes 90% of losses to multiple assuming companies. B Company assumes 30%, A Company retains 10%, with the remainder assumed by other reinsurers.

The reinsurers charged a $ m premium. Under the contract, A Company retained $ m of the premium and established two Funds Withheld Accounts on 12/31/year 1 for the benefit of the reinsurers. The remaining $ m was paid to the reinsurers on 12/31/year 1 as a margin.

The settlement date is 60 days after each calendar quarter. Loss payments due to A Company are made first out of the Funds Withheld Accounts and then in cash. During the term of the reinsurance contract the two Funds Withheld Balances are computed on each settlement date as follows:

Funds Withheld Balance-(at the prior settlement date) Less quarterly loss payments-(including cash payments)
Plus Interest computed at a 7.5% annual rate, compounded quarterly.

At the time incurred ceded losses under this contract

exceed $ m. Any positive Funds Withheld Balances shall be combined, and one combined Funds Withheld Balance shall be calculated from that date forward.

A Company may commute the contract at the end of any calendar quarter with notice if there is a positive balance in the funds withheld account, and will on commutation receive any positive funds withheld balances. If the Funds Withheld balance is not positive, the contract can only be commuted by mutual agreement between A Company and the reinsurers. Business covered under the contract included workmen's compensation business. Losses subject to the contract included losses and loss adjustment expenses paid by A Company on or after 12/31/year 1 for accident years aaaa-bbbb which are accident years prior to 12/31/year 1. Losses covered include paid losses in excess of A Company's retention, subject to a loss corridor and subject to the aggregate limit.

B Company has booked reserves as of 12/31/year 1 based on five cash flow scenarios, assigning probabilities of occurrence to each. Each of the five scenarios reflect an ultimate incurred loss and payout pattern.

ANALYSIS:

A non-life insurance company such as B Company is required to compute its taxable income under I.R.C. § 832. (See I.R.C. § 831). Under this statutory provision, gross income includes amounts earned from investment and underwriting income, computed on the basis of the underwriting and investment exhibit of the annual statement approved by the National Association of Insurance Commissioners. I.R.C. § 832(b)(1)(A). Underwriting income is defined as the premiums earned on insurance contracts during the taxable year less losses incurred and expenses incurred. I.R.C. § 832(b)(3).

The annual statement is not controlling for federal income tax purposes, but is instead a guide in computing taxable income. Support for this position is found at Treas. Reg. § 1.832-4(a)(2) which provides that the annual statement will be followed insofar as it is not inconsistent with the provisions of the Internal Revenue Code. See also, Western Casualty & Surety Co. V. Commissioner, 571 F. 2d 514 (10th Cir. 1978), aff'g 65 T.C 897 (1976), and Home Group Inc. v. Commissioner, 875 F. 2d 377 (2d Cir. 1989), aff'g City Investing Co. v. Commissioner,

T.C.Memo. 1987-36. Furthermore, in both Minnesota Lawyers Mutual Ins. Co. v. Commissioner, 285 F. 3d 1086 (8th Cir. 2002), aff'g, T.C. Memo. 2000-203 and Physicians Ins. Co. of Wisconsin Inc. v. Commissioner, T.C. Memo. 2001-304, the taxpayers argued that the annual statement controlled so the IRS was prohibited from adjusting their unpaid loss reserves. The courts rejected this argument holding that the fact that the reserve had been accepted for annual statement purposes was not controlling for federal income tax. Likewise, the fact that a contract is accepted as insurance for annual statement purposes is not controlling for federal income tax purposes.

Insurance is a contractual security against possible anticipated loss. Neither the Internal Revenue Code nor the regulations specifically define the term insurance contract. For federal tax purposes, the critical factors in qualifying as insurance have historically been the presence in a binding arrangement of risk-shifting(from the insured's perspective) and risk distribution (from the insurer's perspective). Helvering v. LeGierse, 312 U.S. 531, 539 (1941); Gulf Oil Corp. v. Commissioner, 914 F.2d 396, 411 (3d. Cir. 1990). The risk transferred pursuant to an insurance contract must be a risk of economic loss. Allied Fidelity Corp. v. Commissioner, 66 T.C. 1068 (1976), aff'd., 572 F.2d 1190 (7th Cir. 1978), cert. denied, 439 U.S. 835 (1978). In addition, the risk must be an insurance risk as opposed to a business risk. (See, Rev. Rul. 68-27, 1968-1 C.B. 315. Organization that issues medical service contracts to groups of individuals and furnishes direct medical services to the subscribers by means of a salaried staff of doctors is not an insurance company. Although an element of risk exists, it is not an insurance risk, but a normal business risk of an organization engaged in furnishing medical services on a fixed price basis.)

Reinsurance is a contract where one insurance company (ceding company) transfers some or all of the risk it has assumed from policyholders to another insurance company (assuming company). Reinsurance is commonly used to mitigate the restrictions of regulatory accounting. Regulators are concerned with solvency, and require that companies immediately recognize expenses, but defer related premium income over the policy exposure period. Different forms of transactions have been developed that allow the ceding company to improve its reported earnings and surplus by transferring its policy liabilities to a reinsurer (assuming company) in exchange for a ceding commission. These transactions are accepted as insurance

transactions for federal tax purposes where the reinsurer (assuming company) is assuming insurance risk.[1]

In determining whether or not there has been a transfer of insurance risk, we look to Rev. Rul. 89-96, 1989-2 C.B. 114. This ruling involved 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. However, Y had insurance coverage with a limit of $30x. Y was therefore 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. Rev. Rul. 89-96 held 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 concluded that these risks are not an insurance risk.[2] In other words, Rev. Rul. 89-96 determined that

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[1] Loss portfolio transfer is a type of retroactive reinsurance transaction entered into in order to obtain surplus relief. In this type of transaction the ceding company increases its surplus to policyholders by the transfer of loss obligations already incurred in excess of the consideration paid, or where the consideration paid by the ceding company to the assuming company is derived from present value or discounting concepts based on anticipated investment income. Insurance Accounting & Systems Association, Inc., Property-Casualty Insurance Accounting, Seventh Edition 1998, p. 10-4.

[2] See also Beech Aircraft Corp. v. United States, 84-2 U.S.T.C. ¶ 9803 (D. Kan. 1984), aff'd 797 F.2d 920 (10th Cir. 1986) which involved an arrangement whereby Beech established a Bermuda-licensed company to cover its product liability risk. In the first year of its operation, Beech paid this company $1.5 million for two layers of coverage: losses up to $2 million and $3 million in excess of $12 million. The arrangement was similar for subsequent years. The company had determined that this premium, when invested during the period of time it would hold the money, would equal the total amount it might pay for any losses occurring under the contract. Beech argued the arrangement constituted insurance because it covered pure risk, which it defined as the variance of actual results from the

a retroactive insurance arrangements where loss has already occurred and the terms of the agreement involve no transfer of risk, other than investment or timing risk, does not constitute insurance for federal income tax purposes.

The A Company contract is also a retroactive contract where events have already occurred to establish liability regarding the underlying policies held by A Company. A Company provided information to B Company at the time the contract was negotiated regarding potential liability of the underlying reserves. Similar to Rev. Rul. 89-96, the liability of B Company under these policies cannot be exactly ascertained, but a potential range of losses were established which included the aggregate limit of the contract.

As part of their underwriting file, B Company created five cash flow scenarios assigning a probability to each. Each of the scenarios reflected a different payouts or ultimate loss, and was used to establish the underwriting loss as reflected on the Annual Statement and tax return for year 1. Both positive and negative net present values are reflected in the scenarios, but it is important to note that none of the scenarios include tax savings as a part of the equation.

The Service contends that in essence, Revenue Ruling 89-96 equates the tax savings received, when booked as an underwriting loss, to an additional premium which the taxpayer can invest to cover expected claims. Therefore, to evaluate the economics of the transaction, this tax savings along with the actual premium is compared to the net present value (NPV) of the anticipated losses. If the NPV of the anticipated losses do not materially exceed the premium plus the tax savings, the transaction does not transfer insurance risk for federal income tax purposes.

B Company provided the Service with its risk transfer analysis under Statement of Statutory Accounting Principles

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expected outcome of hazard. The uncertainties were whether any accidents would occur and the severity of the associated losses. Losses might have to be paid earlier than expected, reducing investment income. Beech acknowledged that the time of payment risk is traditionally viewed as an investment rather than an insurance risk and was unable to identify any insurance authority who agreed with its statement that time of payment risk is an insurance risk as opposed to an investment risk.

(SSAP) 62. B Company's analysis includes the cash flows related to the five scenarios used to compute its unpaid loss reserve. Each cash flow includes the ultimate loss, and payout pattern. B Company combined the two Funds Withheld Accounts at inception of the contract. The Service believes this is appropriate for scenarios 2 through 5 which reflect an ultimate loss in excess $ m. Scenarios 4 and 5 reflect an unpaid ultimate loss of $ m which is the aggregate limit of the contract with a slow and fast payout pattern. The cash flows represent 100% of the contract of which B Company has a 30% participation. For purposes of computing NPV, B Company selected a 4.96% interest rate which represents the applicable quarterly long-term Federal Rate for December Year 1. Due to the Funds Withheld provisions of the contract, for the purposes of computing NPV, the premium and interest posted in the Funds Withheld Account was deemed received by B Company when losses payments were payable to A Company. Thus, in B Company's computation, a NPV for the premium and interest is computed, offset by the NPV of the offsetting loss payment.

In applying Rev. Rul. 89-96, the Service computed the tax benefits based on a 35% federal tax rate since this is the rate that E Company was subject to in year 1 on their consolidated tax return, and an effective state income tax rate of X%. B Company filed its tax returns for 12/31/year 1 through 12/31/year 4 as part of the consolidated return of E Company. Reserve discounting under I.R.C. §846 was also considered. Although Rev. Rul. 89-96 does not specify an investment rate to compute the NPV of the losses, the Service was conservative in its approach. It selected an interest rate for each scenario which reflected the amount of time the premium and tax savings could be invested before loss payments were due. It used the applicable federal rate under Code Section 1274(d) which provides for short-term, mid-term, and long-term rates. Based on this analysis, a 4.96% rate was selected for both scenarios 4 and 5 since cash payments by B Company to A Company would not occur until 10 years after contract inception. The rate selected was the December quarterly long-term rate which represents a relatively risk free rate in effect at the inception of the contract.

In Rev. Rul. 89-96, it was expected that the reinsurer (assuming company) would be liable for the $100X limit of the contract. In this case, B Company has determined five different possibilities based on its underwriting expertise and the information provided by A Company. The first step in the

analysis is to compute the NPV of each scenario without considering the tax benefits.

Tax savings do not need to be considered with respect to scenarios 1, 2, and 3 since they fail Rev. Rul. 89-96 even without factoring in the tax savings. In contrast, scenarios 4 and 5 reflect a negative NPV before tax savings are considered. The Service therefore computed the tax savings in two different manners. The first is to consider the actual tax benefit B Company claimed on its year 1 tax return. In addition, the Service has estimated the tax savings B Company would have received, if it had claimed the aggregate limit of the contract for the purposes of computing their underwriting loss instead of $ m.

No insurance risk has transferred under Rev. Rul. 89-96. After consideration of all reasonable scenarios, the premium received plus the tax savings invested at a 4.96% rate of return will allow B Company to pay any potential claims without any additional risk of loss. Like the transaction described in Rev. Rul. 89-96, the contract here creates certain risks for B Company, but these risks are investment or timing risks, and not insurance risks.

CONCLUSION:

The annual statement and SSAP 62 are not controlling for federal income tax purposes. While an arrangement that fails the risk transfer requirements of SSAP 62 is almost certain to fail the risk transfer requirements for federal income tax purposes, satisfying SSAP 62 is no guarantee of success for federal income tax purposes. The controlling authority for federal income tax purposes is Rev. Rul. 89-96. Although this revenue ruling was written in the context of an insurance transaction, its rational is equally applicable to this reinsurance transaction.

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