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IRS Rules That Quota Share Reinsurance Arrangements Are “Insurance” and Continues to Apply Prior Principles

On December 11, 2009, in Private Letter Rulings 200950016 and 200950017, the IRS ruled that quota share reinsurance arrangements qualified as “insurance” for federal income tax purposes based upon the fact that both risk shifting and risk distribution were present in the arrangements. The rulings are important because they confirm the application of insurance principles derived from prior IRS rulings. Indeed, the rulings appear to be the basis for the holding of Rev. Rul. 2009-26.

In both rulings, Company is a captive insurance company owned by certain individuals (Individuals) who also own a number of other entities. The entities owned by the Individuals, not including Company, enter into insurance contracts with Insurer, an insurance company unrelated to Company, to secure insurance covering workers’ compensation, general liability, property, automobile, and crime risks. Insurer also enters into a number of identical contracts with parties unrelated to Company. Insurer retains the risk of loss on all of these contracts that is above certain dollar thresholds (up to the limits of the underlying contracts), but cedes the remaining risks to Reinsurer A, an insurance company that also is unrelated to Company. Reinsurer A retains the risk on the ceded business up to a specified dollar amount, and through a retrocession agreement cedes the remaining reinsured risk to Reinsurer B. Reinsurer B is a foreign segregated cell insurance company (apparently also unrelated to Company) that retrocedes to Company and other insurance companies on a quota share basis the entire layer of risks retroceded to Reinsurer B 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.

The IRS ruled that the quota share reinsurance agreement between Company and Reinsurer B is “insurance” because the agreement includes both risk shifting and risk distribution. The IRS stated that “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.” The IRS also provided that risk distribution reflects the idea of the “law of large numbers,” pursuant to which insurers take on numerous relatively small independent risks to smooth out their losses to match more closely their receipt of premiums.

Under the foregoing facts, the IRS concluded that risk shifting had occurred with respect to the quota share reinsurance arrangement because multiple entities, including entities not related to Company, had entered into identical insurance contracts with Insurer, thereby shifting their risk of loss to Insurer. Risk distribution also had occurred because none of the multiple insured entities controlled Company and none of the insureds in essence was paying for a significant portion of its own losses. Although a portion of the insured risk was retroceded to Reinsurer A and a portion of that risk was retroceded to Reinsurer B

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before it was retroceded to Company, those transactions implicitly were not viewed as changing the fundamental nature of the risk shifting and risk distribution that related to the underlying contracts. Furthermore, since the quota share arrangement between Reinsurer B and Company otherwise bore all the hallmarks of true insurance, the arrangement was ruled to be insurance for federal income tax purposes.

The IRS also concluded that Company is an “insurance company” under Internal Revenue Code § 831. Company represented that its sole business is the reinsuring of risks pursuant to the quota share agreement with Reinsurer B. Therefore, because more than half of Company’s business is reinsuring risk underwritten by insurance companies, it is an “insurance company.”

These rulings are consistent with prior IRS revenue rulings. Indeed, the rulings appear to be the basis for the holding in Rev. Rul. 2009-26, in which the IRS held that a reinsurance company would be treated as an insurance company for federal income tax purposes, even though it reinsured business from only one ceding company, because the reinsured risks related to 10,000 unrelated customers of the ceding company, thereby ensuring that the reinsured risks reflected both risk shifting and risk distribution.

The rulings also follow the positions taken by the IRS in Rev. Rul. 2005-40, in which the IRS provided guidance on what constituted the requisite risk distribution in order to be considered insurance for federal income tax purposes, and Rev. Rul. 2007-47, in which the IRS, quoting legislative history of the McCarran-Ferguson Act, stated that “[t]he theory of insurance is the distribution of risk according to hazard, experience, and the law of averages.” The position taken in the recent rulings is also consistent with sourcing and character rules under § 4371 and the regulations under § 953.



If you have any questions about this development, please feel free to contact any of the attorneys listed below or the Sutherland attorney with whom you regularly work.

Michael R. Miles	202.383.0204	michael.miles@sutherland.com
Christopher Ocasal	202.383.0818	chris.ocasal@sutherland.com
Carol P. Tello	202.383.0769	carol.tello@sutherland.com
W. Mark Smith	202.383.0221	mark.smith@sutherland.com
Thomas A. Gick	202.383.0191	tom.gick@sutherland.com
William J. Walderman	202.383.0243	william.walderman@sutherland.com