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What Constitutes Transfer Of Risk? Where Is The IRS Headed Now?

In our 2005 *Client Alert* ["What Is Insurance For The Taxman?", July 13, 2005"], we observed that the question of what constitutes insurance for federal income tax ("FIT") purposes has been, and will continue to be, the subject of controversy. We noted this affects the deductibility of premiums and whether an entity qualifies for the generally more favorable tax treatment accorded insurance companies under the Internal Revenue Code (the "Code"). The question arises in connection with both reinsurance and insurance transactions. This *Client Alert* discusses how the IRS continues to fan the controversy.

IRS Standards

Although the Code does not define the term "insurance", the U.S. Supreme Court has held that two elements must be present: (1) risk shifting or transfer of risk, and (2) risk distribution. *Helvering v. Le Gierse*, 312 U.S. 531 (1941). In addition, the risk transferred must be an insurance risk, as opposed to simply a timing or investment risk.

The IRS has struggled with the application of these criteria. For example, the IRS stood steadfast behind its discredited "economic family" theory developed in 1977 in which it took the position that no risk can be transferred between affiliates regardless of the number or size of unrelated risks insured by the insurer. The theory was never accepted by the courts and the IRS finally announced in 2001 in Rev. Rul. 2001-31 that it had abandoned the theory. [See LLBL January 2003 *Client Alert* "Recent IRS Captive Insurance Company Rulings"].

Apparently undaunted, the IRS issued proposed regulations in September 2007 that would have treated certain arrangements between related parties and their captive insurers as inter-company transactions for which a deduction would not be allowed. Many viewed this as the economic family theory in guise. After an intense lobbying effort by interested groups, the IRS withdrew its proposed regulations in February, 2008.

The IRS has also issued three pronouncements over the past year that, considered with the withdrawn proposed regulations, illustrate that the IRS continues to struggle with the Supreme Court's risk transfer and risk distribution criteria and is unwilling or incapable of providing meaningful, consistent and well thought out guidance as to how these criteria should be applied.

Accounting Standards

Before discussing the IRS pronouncements, a review of the accounting treatment of risk transfer is in order. While the actual accounting for reinsurance differs under GAAP and SSAP, the criteria underlying the assessment of risk transfer are essentially the same. In order for a contract to be treated as reinsurance, both GAAP and SSAP require that the risk transferred be an insurance risk and that there be a reasonable possibility that the reinsurer may realize a significant loss from the transaction. In defining insurance risk, SSAP 62, § 10 states "Insurance risk is fortuitous—the possibility of adverse events occurring is outside the control of the insured." Both SSAP 62 and FAS No. 113 conclude that a reinsurer shall not be considered to have transferred significant insurance risk if the probability of a significant variation in the amount or timing of payments by the reinsurer is remote.

Thus, both GAAP and SSAP appear to have adopted a bifurcated approach. In order to determine whether a contract qualifies for reinsurance accounting, you must first determine whether the amount or timing¹ of the reinsurer's payments may vary significantly and whether this variance is beyond the control of the parties to the contract. If the answer to these questions is yes, the contract transfers insurance risk. Then and only then do you evaluate the degree of risk transfer, i.e., whether there is a reasonable possibility that the reinsurer may realize a significant loss.

As noted in our November 19, 2004 *Client Alert* ["Caveat Emptor-Caveat Seller, November 19, 2004"], the application of the risk transfer criteria set out in FAS No. 113 and SSAP 62 for rein-

insurance transactions has apparently been infrequently applied by accounting overseers (e.g., auditors and government regulators) to direct insurance contracts. However, the current scrutiny being afforded so-called non-traditional reinsurance arrangements may have accounting ramifications for insurers writing direct contracts in which little or no insurance risk is transferred. GAAP guidance found in FAS No. 5, paragraph 44 in conjunction with other FASB and AICPA guidance could be used to require that FAS No. 113 risk transfer criteria be used in the assessment of risk transfer under direct contracts written by insurers, particularly contracts providing retroactive coverage. While SSAP guidance is somewhat less clear in this area, there is also sufficient underlying rationale in statutory accounting concepts to use SSAP 62 risk transfer criteria for direct insurance.

The National Association of Insurance Commissioners ("NAIC") and the Financial Accounting Standards Board ("FASB") have undertaken reviews designed to clarify when contracts structured as insurance or reinsurance qualify for insurance or reinsurance accounting. While neither the NAIC nor the FASB have as yet adopted changes which clarify the risk transfer criteria required for accounting treatment as insurance or reinsurance, the NAIC has adopted a number of changes which add additional disclosures to the interrogatories included in property and casualty insurance companies' annual statements. The FASB has indicated it expects to issue an exposure draft on what constitutes adequate risk transfer in insurance and reinsurance contracts in the second quarter of this year.

Recent IRS Pronouncements

The three pronouncements issued by the IRS deal with the issue of whether a contract will be treated as insurance or reinsurance for FIT purposes. While these pronouncements purport to be relatively straightforward applications of existing principles, they raise troubling questions

about the direction the IRS is taking in assessing whether a transaction satisfies the risk transfer criteria used for FIT purposes.

FAA 20072502F

FAA 20072502F, which is legal advice issued by an IRS associate area counsel to a revenue agent, analyzes whether a retroactive reinsurance contract transfers sufficient risk for the reinsurer to treat the contract as reinsurance for FIT purposes. The reinsurer treated the contract as retroactive reinsurance for NAIC annual statement purposes and as a reinsurance contract for FIT purposes. The reinsurer booked reserves as of the inception date (12/31 of year 1 of the contract) based on five cash flow scenarios constructed for SSAP 62 risk transfer analysis purposes, assigning probabilities to each. Each of the five scenarios reflects an ultimate incurred loss and payout pattern.

The FAA notes that the reinsurer provided the IRS with its SSAP 62 risk transfer analysis, but concludes that the test for determining whether there has been an adequate transfer of insurance risk for FIT purposes is set forth in Rev. Rul. 89-96, 1989-2 C.B. 114.

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 [sic] is equally applicable to this reinsurance transaction.

Rev. Rule 89-96 involves a situation where company Y incurred a liability to injured persons, the exact amount of which

could not be ascertained but which was expected to be substantially in excess of \$130x. Company Y had \$30x in pre-existing liability insurance coverage, so it purchased \$100x in excess liability insurance from the taxpayer, a commercial insurance company, for which it paid a \$50x premium. On its annual statement, the taxpayer included the \$50x in earned premium and \$100x in unpaid losses, and on its federal income tax return treated the gross premium as fully earned and included the \$100x (appropriately discounted) in its incurred losses. Rev. Rul. 89-96 concluded:

From the economic terms of the contract it was reasonable to expect that the amount of net 'premium' received from Y (gross premium less loading), the amount of tax savings resulting from the increased deduction for 'losses incurred,' and the investment income earned on those amounts would probably exceed its maximum anticipated liability, \$100x, under its contract with Y.

The FAA concludes that the reinsurance transaction failed the risk transfer test enunciated in Rev. Rul. 89-96 because in all of the five cash flow scenarios used in the reinsurer's SSAP 62 cash flow analysis, the net present value of the anticipated losses was less than the premium plus federal and state tax benefits received by the reinsurer². Given these facts, this conclusion is relatively unsurprising and can even be viewed as consistent with the risk transfer test established in SSAP 62 and FAS No. 113 because in all likelihood the cash flow analysis did not establish that there was a reasonable possibility that the reinsurer might realize a significant loss from the transaction.

What is troubling, however, is the test which the FAA adopts:

"If the NPV of the anticipated losses do not materially exceed the premium plus the tax savings, the transaction does not transfer risk

for federal income tax purposes.”

Read literally, this means that unless an insurer can manage its investments to outperform the discount rate established in the Code (which was used by the agent in calculating NPV), an insurer or reinsurer must expect to make a loss for a contract to be treated as insurance for FIT purposes. This is a far cry from the “reasonable possibility of a significant loss” test used in SSAP 62 and FAS No. 113. Under the test adopted in the FAA, qualification of a contract as insurance depends entirely on investment performance since no insurance company will write business with the expectation of making a loss. The increased weight which the FAA formula places on investment performance seems inconsistent with the IRS’s conclusion in Rev. Rul. 89-96 that the risk transfer test requires that insurance rather than investment risk be transferred. The rigid and unworkable standard set out in the FAA is not consistent with the IRS’s historical emphasis on “insurance” risk. Moreover, FAA 20072502F raises the troubling prospect that the IRS is headed in a different direction than the NAIC and FASB in terms of its risk transfer test.

Rev. Rul. 2007-47 and PLR 200711017

Like the retrospective insurance arrangement at issue in Rev. Rul. 89-96, Rev. Rul. 2007-47 and PLR 200711017 both involve arrangements in which an insured or reinsured transferred the risk of losses which had already been triggered.

(a) Rev. Rul. 2007-47

Rev. Rul. 2007-47 involves an arrangement entered into between an unrelated insurance company and a company which was required by governmental regulations to remediate the harm caused by its business processes. The regulations required that the company restore its business location to its pre-process condition at the time it ceases the harmful business process. The Ruling notes that the amount and timing of the

costs the company will incur to remediate the property will be a function of many factors, including the future cost of wages and materials, changes in government regulations and the timing of the company’s decision to terminate its business processes. At the time the company began its business process, it estimated that the present value of its future remediation costs was \$150x. At that time, it entered into an arrangement with the unrelated insurer to pay the insurer \$150x in return for the insurer’s agreement to indemnify the company for its remediation costs up to a limit of \$300x.

(b) PLR 200711017

PLR 200711017 involved a parent and subsidiary, both of which were property and casualty reinsurance companies. The subsidiary entered into a portfolio reinsurance agreement with its parent which transferred to the parent, on a 100% quota share basis, all of the subsidiary’s liability for its net losses, including loss adjustment expenses and incurred but not reported losses, arising from losses incurred prior to a date preceding the date of the agreement, up to an agreed aggregate limit. In consideration, the subsidiary paid the parent the amount of its statutory reserves for the transferred book. This premium was placed in a notional account, credited with interest and debited for losses. If prior to commutation or termination, claims exceeded the balance in the notional account, the parent was obligated to pay the subsidiary the amount necessary to pay the claims. Any positive balance in the notional account at termination was to be paid by the subsidiary to the parent.

Both Rev. Rul. 2007-47 and PLR 200711017 stress that the determination whether an arrangement constitutes insurance for FIT purposes derives from all the facts surrounding each individual case. Both discuss “fortuity” as a necessary element for an arrangement to qualify as insurance for FIT purposes without defining what that means in the context of a risk transfer analysis. And, finally, both analo-

gize the arrangements in question to the arrangement presented in Rev. Rul. 89-86 and conclude that the arrangements do not constitute insurance for FIT purposes because the arrangements transfer only timing and investment risks.

In reaching this conclusion, however, both Rev. Rul. 2007-47 and PLR 200711017 miss the key to Rev. Rul. 89-86. In Rev. Rul. 89-86, both the insured and the insurer knew at the time of the contract the amount that the insurer would have to pay. Under these circumstances, the IRS was correct in concluding that the only risks transferred were investment and timing risks. In both Rev. Rul. 2007-47 and PLR 200711017, however, the amount the insurer will ultimately have to pay is uncertain. As a result, the contracts reviewed in both these rulings transfer the risk of unanticipated loss as well as timing and investment risks.

Nor has the IRS provided any guidance to how the “fortuity” test applies in determining whether an arrangement transfers risk for FIT purposes. If by fortuitous the IRS means unforeseeable, the uncertain amount of loss, which is outside the control of either party, should satisfy this requirement. Surely, the fortuity criterion cannot require that the prospect of any loss at all be uncertain. *Commissioner v. Treganowan*, 183 F.2d 288 (2d Cir. 1950). “Even death may be considered fortuitous, because the time of its occurrence is beyond control.” *Id.*, at 290. In both Rev. Rul. 2007-47 and PLR 200711017, the IRS ignores the uncertainty as to the amount of the loss but this uncertainty, in fact, results in the contracts transferring a risk of loss undetected by the IRS in the rulings, as well as investment and timing risks.

SSAP 62, § 10 addresses insurance risk as follows: “Insurance risk involves uncertainties about both (a) the ultimate amount of net cash flows from premiums, commissions, claims, and claims settlement expenses (underwriting risk) and (b) the timing of the receipt and payment of those cash flows

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(timing risk). Actual or imputed investment returns are not an element of insurance risk. Insurance risk is fortuitous—the possibility of adverse events occurring is outside the control of the insured.” Where the ultimate amount to be paid by the insurer is uncertain and beyond the control of either the insured or insurer, shouldn’t this risk, transferred in each case to a commercial insurance company, be considered an underwriting (i.e. insurance) risk?

Under the bifurcated approach in both SSAP 62 and FAS No. 113, the contracts reviewed in both Rev. Rul. 2007-47 and PLR 2007 11017 should be viewed as transferring insurance risk because the amount and timing of the insurer’s payments is uncertain and beyond the control of either party. Thus, the IRS should have proceeded to the second part of the test, i.e., whether sufficient risk was transferred to satisfy the risk transfer criterion.

Conclusion

It is difficult to say from these three pronouncements where the IRS is headed in its analysis of whether sufficient risk transfer is present for FIT purposes, because these rulings fail to articulate a consistent approach to this issue. Far from providing guidance as to what constitutes risk transfer, these rulings have muddied the waters by confusing the test for determining whether a contract transfers “insurance risk” with the test for determining whether sufficient risk has been transferred. In doing so, the IRS has adopted standards inconsistent with FASB and NAIC standards, ignored the basis for prior rulings and relied on a contradictory, undefined, subjective and malleable “fortuity” standard.

The recent aborted effort by the IRS to promulgate regulations that would have negatively impacted reinsurance transactions among related parties coupled with pronouncements such as those discussed above demonstrates a continuing lack of reasoned and consistent analysis by the IRS concerning what constitutes risk transfer for FIT purposes. In our view, the inability of the IRS to provide consistent guidance in this area is a direct result of its curious resistance to aligning its thinking with the insurance accounting profes-

sionals at the NAIC and FASB. Hopefully, the IRS will take note of the FASB’s anticipated exposure draft concerning standards for determining risk transfer. In our view, there is no reason why arrangements which transfer sufficient insurance risk to be considered insurance or reinsurance under the accounting guidance (as determined by the NAIC and FASB) should not also transfer sufficient insurance risk for FIT purposes.

1. We question whether a variance in timing alone would be sufficient basis for determining that a contract transfers insurance risk.

2. Note that the FAA has no problem applying the risk transfer test developed in a direct insurance context to a reinsurance transaction. This suggests that the IRS views the risk transfer requirement to be the same for both direct insurance and reinsurance transactions.

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