Section 831.—Tax on Insurance Companies Other Than Life Insurance Companies

(Also § 162; 1.162–1.)

Insurance, federal income tax purposes. This ruling considers four circumstances in which arrangements between unrelated entities do, and do not, constitute insurance for federal income tax purposes and whether the issuer qualifies as an insurance company for federal income tax purposes.

Rev. Rul. 2005–40

ISSUE

Do the arrangements described below constitute insurance for federal income tax purposes? If so, are amounts paid to the issuer deductible as insurance premiums and does the issuer qualify as an insurance company?

FACTS

Situation 1. *X*, a domestic corporation, operates a courier transport business covering a large portion of the United States. *X* owns and operates a large fleet of automotive vehicles representing a significant volume of independent, homogeneous risks. For valid, non-tax business purposes, *X* entered into an arrangement with *Y*, an unrelated domestic corporation, whereby in exchange for an agreed amount of "premiums," *Y* "insures" *X* against the risk of loss arising out of the operation of its fleet in the conduct of its courier business.

The amount of "premiums" under the arrangement is determined at arm's length according to customary insurance industry rating formulas. *Y* possesses adequate capital to fulfill its obligations to *X* under the agreement, and in all respects operates in accordance with the applicable requirements of state law. There are no guarantees of any kind in favor of *Y* with respect to the agreement, nor are any of the "premiums" paid by *X* to *Y* in turn loaned back to *X*. *X* has no obligation to pay *Y* additional premiums if *X*'s actual losses during any period of coverage exceed the "premiums" paid by *X*. *X* will not be entitled to any refund of "premiums" paid if *X*'s actual losses are lower than the "premiums" paid during any period. In all respects, the parties conduct themselves consistent with the standards applicable to an insurance arrangement between unrelated parties, except that *Y* does not "insure" any entity other than *X*.

Situation 2. The facts are the same as in Situation 1 except that, in addition to its arrangement with *X*, *Y* enters into an arrangement with *Z*, a domestic corporation unrelated to *X* or *Y*, whereby in exchange for an agreed amount of "premiums," *Y* also "insures" *Z* against the risk of loss arising out of the operation of its own fleet in connection with the conduct of a courier business substantially similar to that of *X*. The amounts *Y* earns from its arrangements with *Z* constitute 10% of *Y*'s total amounts earned during the taxable year on both a gross and net basis. The arrangement with *Z* accounts for 10% of the total risks borne by *Y*.

Situation 3. *X*, a domestic corporation, operates a courier transport business covering a large portion of the United States. *X* conducts the courier transport business through 12 limited liability companies (LLCs) of which it is the single member. The LLCs are disregarded as entities separate from *X* under the provisions of § 301.7701–3 of the Procedure and Administration Regulations. The LLCs own and operate a large fleet of automotive vehicles, collectively representing a significant volume of independent, homogeneous risks. For valid, non-tax business purposes, the LLCs entered into arrangements with *Y*, an unrelated domestic corporation, whereby in exchange for an agreed amount of "premiums," *Y* "insures" the LLCs against the risk of loss arising out of the operation of the fleet in the conduct of their courier business. None of the LLCs account for less than 5%, or more than 15%, of the total risk assumed by *Y* under the agreements.

The amount of "premiums" under the arrangement is determined at arm's length according to customary insurance industry rating formulas. *Y* possesses adequate capital to fulfill its obligations to the LLCs under the agreement, and in all respects

operates in accordance with the licensing and other requirements of state law. There are no guarantees of any kind in favor of *Y* with respect to the agreements, nor are any of the "premiums" paid by the LLCs to *Y* in turn loaned back to *X* or to the LLCs. No LLC has any obligation to pay *Y* additional premiums if that LLC's actual losses during the arrangement exceed the "premiums" paid by that LLC. No LLC will be entitled to a refund of "premiums" paid if that LLC's actual losses are lower than the "premiums" paid during any period. *Y* retains the risks that it assumes under the agreement. In all respects, the parties conduct themselves consistent with the standards applicable to an insurance arrangement between unrelated parties, except that *Y* does not "insure" any entity other than the LLCs.

Situation 4. The facts are the same as in Situation 3, except that each of the 12 LLCs elects pursuant to § 301.7701–3(a) to be classified as an association.

LAW

Section 831(a) of the Internal Revenue Code provides that taxes, computed as provided in § 11, are imposed for each taxable year on the taxable income of each insurance company other than a life insurance company. Section 831(c) provides that, for purposes of § 831, the term "insurance company" has the meaning given to such term by § 816(a). Under § 816(a), the term "insurance company" means any company more than half of the business of which during the taxable year is the issuing of insurance or annuity contracts or the reinsuring of risks underwritten by insurance companies.

Section 162(a) provides, in part, that there shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business. Section 1.162–1(a) of the Income Tax Regulations provides, in part, that among the items included in business expenses are insurance premiums against fire, storms, theft, accident, or other similar losses in the case of a business.

Neither the Code nor the regulations define the terms "insurance" or "insurance contract." The United States Supreme Court, however, has explained that in order for an arrangement to constitute insurance for federal income tax purposes, both risk shifting and risk distribution must be present. *Helvering v. Le Gierse*, 312 U.S. 531 (1941).

The risk transferred must be risk of economic loss. *Allied Fidelity Corp. v. Commissioner*, 572 F.2d 1190, 1193 (7th Cir.), *cert. denied*, 439 U.S. 835 (1978). The risk must contemplate the fortuitous occurrence of a stated contingency, *Commissioner v. Treganowan*, 183 F.2d 288, 290–91 (2d Cir.), *cert. denied*, 340 U.S. 853 (1950), and must not be merely an investment or business risk. *Le Gierse*, at 542; Rev. Rul. 89–96, 1989–2 C.B. 114.

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. Risk distribution incorporates the statistical phenomenon known as the law of large numbers. Distributing risk allows the insurer to reduce the possibility that a single costly claim will exceed the amount taken in as premiums and set aside for the payment of such a claim. By assuming numerous relatively small, independent risks that occur randomly over time, the insurer smooths out losses to match more closely its receipt of premiums. *Clougherty Packing Co. v. Commissioner*, 811 F.2d 1297, 1300 (9th Cir. 1987).

Courts have recognized that risk distribution necessarily entails a pooling of premiums, so that a potential insured is not in significant part paying for its own risks. *Humana, Inc. v. Commissioner*, 881 F.2d 247, 257 (6th Cir. 1989). *See also Ocean Drilling & Exploration Co. v. United States*, 988 F.2d 1135, 1153 (Fed. Cir. 1993) ("Risk distribution involves spreading the risk of loss among policyholders."); *Beech Aircraft Corp. v. United States*, 797 F.2d 920, 922 (10th Cir. 1986) ("'[R]isk distributing' means that the party assuming the risk distributes his potential liability, in part, among others."); *Treganowan*, at 291 (quoting Note, *The New York Stock Exchange Gratuity Fund: Insurance that Isn't Insurance*, 59 Yale L. J. 780, 784 (1950)) ("'By diffusing the risks through a mass of separate risk shifting contracts, the insurer casts his lot with the law of averages. The process of risk distribution, therefore, is the very essence of insurance.'"); *Crawford Fitting Co. v. United States*, 606 F. Supp. 136, 147 (N.D. Ohio 1985) ("[T]he court finds . . . that various nonaffiliated persons or entities facing risks similar but independent of those faced by plaintiff were named insureds under the policy, enabling the distribution of the risk thereunder."); *AMERCO and Subsidiaries v. Commissioner*, 96 T.C. 18, 41 (1991), *aff'd*, 979 F.2d 162 (9th Cir. 1992) ("The concept of risk-distributing emphasizes the pooling aspect of insurance: that it is the nature of an insurance contract to be part of a larger collection of coverages, combined to distribute risk between insureds.").

ANALYSIS

In order to determine the nature of an arrangement for federal income tax purposes, it is necessary to consider all the facts and circumstances in a particular case, including not only the terms of the arrangement, but also the entire course of conduct of the parties. Thus, an arrangement that purports to be an insurance contract but lacks the requisite risk distribution may instead be characterized as a deposit arrangement, a loan, a contribution to capital (to the extent of net value, if any), an indemnity arrangement that is not an insurance contract, or otherwise, based on the substance of the arrangement between the parties. The proper characterization of the arrangement may determine whether the issuer qualifies as an insurance company and whether amounts paid under the arrangement may be deductible.

In Situation 1, *Y* enters into an "insurance" arrangement with *X*. The arrangement with *X* represents *Y*'s only such agreement. Although the arrangement may shift the risks of *X* to *Y*, those risks are not, in turn, distributed among other insureds or policyholders. Therefore, the arrangement between *X* and *Y* does not constitute insurance for federal income tax purposes.

In Situation 2, the fact that *Y* also enters into an arrangement with *Z* does not change the conclusion that the arrangement between *X* and *Y* lacks the requisite risk distribution to constitute insurance. *Y*'s contract with *Z* represents only 10% of the total amounts earned by *Y*, and 10% of total risks assumed, under all its arrangements. This creates an insufficient pool

of other premiums to distribute *X*'s risk. *See* Rev. Rul. 2002–89, 2002–2 C.B. 984 (concluding that risks from unrelated parties representing 10% of total risks borne by subsidiary are insufficient to qualify arrangement between parent and subsidiary as insurance).

In Situation 3, *Y* contracts only with 12 single member LLCs through which *X* conducts a courier transport business. The LLCs are disregarded as entities separate from *X* pursuant to § 301.7701–3. Section 301.7701–2(a) provides that if an entity is disregarded, its activities are treated in the same manner as a sole proprietorship, branch or division of the owner. Applying this rule in Situation 3, *Y* has entered into an "insurance" arrangement only with *X*. Therefore, for the reasons set forth in Situation 1 above, the arrangement between *X* and *Y* does not constitute insurance for federal income tax purposes.

In Situation 4, the 12 LLCs are not disregarded as entities separate from *X*, but instead are classified as associations for federal income tax purposes. The arrangements between *Y* and each LLC thus shift a risk of loss from each LLC to *Y*. The risks of the LLCs are distributed among the various other LLCs that are insured under similar arrangements. Therefore the arrangements between the 12 LLCs and *Y* constitute insurance for federal income tax purposes. *See* Rev. Rul. 2002–90, 2002–2 C.B. 985 (similar arrangements between affiliated entities constituted insurance). Because the arrangements with the 12 LLCs represent *Y*'s only business, and those arrangements are insurance contracts for federal income tax purposes, *Y* is an insurance company within the meaning of §§ 831(c) and 816(a). In addition, the 12 LLCs may be entitled to deduct amounts paid under those arrangements as insurance premiums under § 162 if the requirements for deduction are otherwise satisfied.

HOLDINGS

In Situations 1, 2 and 3, the arrangements do not constitute insurance for federal income tax purposes.

In Situation 4, the arrangements constitute insurance for federal income tax purposes and the issuer qualifies as an insurance company. The amounts paid to the issuer may be deductible as insurance premiums under § 162 if the requirements for deduction are otherwise satisfied.

DRAFTING INFORMATION

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