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MEMORANDUM

Re: IRS Issues Rev. Rul. 2005-40 and Seeks Comments on What Is Insurance

From: Mark H. Kovey

Date: June 20, 2005

Rev. Rul. 2005-40 sets forth four situations that illustrate the IRS position of when adequate risk distribution is or is not present in order for an arrangement to be treated as insurance when there is only one "insured," notwithstanding the arrangement covered a significant volume of independent, homogeneous risks. In Notice 2005-49, the IRS requests comments on what additional guidance should be issued regarding what is insurance, including the issue covered in Revenue Ruling 2005-40.

Rev. Rul. 2005-40 deals with four situations which purport to be insurance. In Situation 1 and 2, X, a domestic corporation, operates a courier transport business with a large fleet of automotive vehicles representing a significant volume of independent, homogeneous risks. It pays a "premium" to Y, an unrelated domestic corporation, for Y to "insure" X against the risk of loss arising out of the operation of its fleet. In Situation 1, Y does not "insure" any entity other than X; in Situation 2, Y also enters into a similar arrangement with unrelated Z to "insure" the risk of operating Z's fleet of vehicles, but the amounts Y earns from its arrangement with Z constitute only 10% of Y's total gross and net earnings annually and the arrangement with Z accounts for only 10% of the total risks borne by Y. The ruling concludes that there is no risk distribution in Situation 1 and insufficient risk distribution in Situation 2 for the arrangements to constitute insurance for federal income tax purposes.

In Situations 3 and 4, the facts are the same as in Situation 1 except that X operates its courier business through 12 limited liability companies (LLCs) of which X is the single owner. In Situation 3, the LLCs are disregarded entities owned by X for federal tax purposes; in Situation 4, each of the 12 LLCs elects to be classified as an association taxable as a separate corporation for federal tax purposes. In both situations, each LLC accounts for between 5 and 15% of the total risk assumed by Y. With respect to Situation 3, the ruling concludes that there is no risk distribution, and therefore no insurance, because the LLCs are disregarded entities for federal tax purposes. It concludes for Situation 4 that the tax treatment of the LLCs as separate entities provides the requisite risk distributions for the arrangement to be treated as insurance. Therefore, the assuming company may be treated as an insurance company and the amounts paid may be treated as insurance premiums deductible under I.R.C. § 162.

It is interesting to note that the ruling isolated the single-insured legal issue for consideration by reciting certain common facts for all four situations. Specifically, in all situations, (a) the premiums paid under the arrangement are determined at arm's length according to customary insurance industry rating formula; (b) Y (the assuming company) possesses adequate capital to fulfill its obligations; (c) Y operates in all respects in accordance with state law requirements; (d) there are no guarantees in favor of Y with respect to the arrangement; (e) none of the premiums paid to Y are loaned back to X (the insured); (f) the insured has no obligation to pay Y additional premiums if actual losses exceed the premiums for any coverage period; (g) the insured will not be entitled to any refund of premiums if actual losses are lower than the premiums paid for any coverage period; and (h) the parties conduct themselves consistent with the standards applicable to an insurance arrangement between unrelated parties, except for the single insured issue. The ruling does not say whether these facts are all required for an arrangement to constitute insurance. Also, although the ruling concludes that the arrangement described in each situation is or is not insurance, it does not address whether the amounts paid might be deductible as some payment other than for insurance, which is an ordinary and necessary business expense.

In Notice 2005-49 (June 17, 2005), the IRS acknowledges that additional guidance is needed on the question of what is insurance and requests comments on issues that should be addressed further. Comments are requested in particular on topics that go beyond traditional "captive" or "self insurance" issues, including (a) the factors to be taken into account in determining whether a cell captive arrangement constitutes insurance and, if so, the mechanics of any applicable federal tax elections; (b) the circumstances under which the qualification as insurance of an arrangement between related parties may be affected by a loan back to the insured of amounts purportedly paid as insurance premiums; (c) the relevance of homogeneity of risks in determining whether risks are adequately distributed for an arrangement to qualify as insurance; and (d) the tax issues raised by transactions involving finite risk. Comments, which are requested by October 3, 2005, are not limited to the topics listed in the Notice.

In a press release accompanying the notice and ruling, the IRS said it is not questioning the vast majority of insurance contracts, which are issued by commercial insurance companies in the ordinary course of business. "Instead, it reminds taxpayers who are parties to smaller one-on-one arrangements that the requirement of risk distribution must be met for the arrangement to qualify as insurance."