

Financial Services - Insurance Tax Bulletin

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Foreign company qualifies as domestic insurance company and reinsurance premiums are deductible business expense

The IRS recently ruled in PLR 201224018, that a general insurance captive licensed and organized under the laws of a foreign country, qualifies as a domestic insurance company for income tax purposes, and that the reinsurance premiums paid to a reinsurance pool are ordinary and necessary business expenses for federal income tax purposes.

A, an individual conducts two lines of business as a sole proprietorship and owns 100% of the stock of Company. Company has elected to be taxed as a domestic corporation. A also owns all the stock of five insured corporations (insured corporations) each involved in a trade or business., Company offers four types of contracts to the five insured corporations, the A sole proprietorship and entity 6. The most significant of which is the P policy, which has coverage for buildings, business personal property, business income and extra expense, legal defense and other related coverages.

To assist in achieving its overall risk distribution, Company takes part in a reinsurance pool (Pool) with 14 insurers. The 14 insurers and their insureds are not related to A nor Company or any of its insureds. Through a reinsurance agreement, Company cedes risk on each line it insures to the Pool. Then, pursuant to a second reinsurance agreement, Company assumes a quota share of the premiums that are paid into the Pool similar in amount to the reinsurance premiums it cedes to the Pool. Also, all members of the Pool issue insurance contracts, charge premiums for them, and use recognized actuarial techniques. Each of the insurers pools all the premiums in its general funds, investigates and pays claims out of those funds, and conducts no business other than the issuing and administration of insurance

contracts. No insured has any obligation to pay any insurer additional premiums if any of their losses during the coverage period exceed the premiums paid by that particular insured. There is a real possibility that an insurer will incur a loss in excess of the premiums it received from its insureds.

The Code defines an insurance company as any company more than half of the business of which during the taxable year is the issuing of insurance or annuity contracts or reinsuring of risks underwritten by insurance companies. According to Case law, a contract must include both risk shifting and risk distribution in order to constitute insurance. In addition, the risk must consider the occurrence of a fortuitous event, not merely an investment or business risk, and must also be thought of as insurance in the commonly accepted way.

After considering a long line of insurance case law and rulings, the IRS concluded that Company directly insures a number of small policies to related insureds, contributes substantial amount of the premiums it receives and related risks to the Pool, and in return Company receives a quota share of the premiums from unrelated insureds from the Pool. The IRS found that through this arrangement, there were a significant number of unrelated covered entities such that none is paying for a significant portion of their own risk. Given that insurance risks are covered, the arrangement achieved risk shifting and distribution; the contracts issued by Company to its insureds were insurance contracts for tax purposes. As such, since the arrangements are insurance contracts and Company is an insurance company for income tax purposes, the premiums the insureds pay to Company is an insurance premium deductible as a necessary and ordinary business expense.

PwC Observation

This ruling is similar to several recent private rulings issued by the Service involving pooling arrangements. Also see PLRs 201219009, 201219010, 201224018. As it has done in the past the IRS reiterates that there must be both risk shifting and risk distribution in order to constitute insurance. In this particular case, the IRS focused on the fact that there was a significant number of unrelated entities such that none was paying for a significant portion of its own risk.

For further information, please feel free to contact Anthony DiGilio at (703) 918-4812 or contact your local insurance tax professional.

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