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Department of the Treasury
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Contact Person:

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Legend

Plan =

State Law =

Month =

Year =

State =

Old Plan =

Group A Carrier =

Group B Carrier =

Group C Carrier =

Commissioner =

Department =

Administrator =

Reinsurance Mechanism =

Excess Amount =

Collective Retention Amount =

Administration Expenses =

Fund =

Dear

This is in response to your March 17, 1999 letter (and to your subsequent correspondence dated April 22 and May 11, 1999) requesting a ruling that the Plan is taxable as an insurance company under the provisions of § 831 of the Internal Revenue Code.

Facts

The Plan is an unincorporated statutory association of insurance carriers. It was established in Year pursuant to State Law for the purposes of providing a new residual market mechanism in State for providing Worker's' Compensation Insurance to employers unable to procure such insurance through ordinary methods. The Plan replaced State's Old Plan which was in effect prior to the Plan's formation. The Plan has been approved by the Commissioner (which also regulates it) and commenced operations on January 1, Year. The Plan is required to file quarterly financial reports with the Department. The Plan has not, as yet, filed a federal income tax return for Year.

During the first Period the Plan is operative (each of the Plan's one year policy periods is referred to as a Plan Period), employers previously assigned to the Old Plan were not renewed by the Old Plan carriers. Instead, those employers were informed about options they were entitled to exercise with respect to the Plan and were given an opportunity to complete an application for coverage from a Group A or a Group B Carrier. Under the Plan, each Group A and Group B Carrier is responsible for the losses incurred by its respective insured employers from the effective date of the new policies each underwrites. By providing insurance coverage through a residual market mechanism, the Plan is designed to guarantee insurance coverage and quality loss prevention and control services for employers it covers.

The Commissioner has appointed Administrator as the Plan's and the Reinsurance Mechanism's administrator. Administrator is responsible for the Plan's general administration, including the development of operating rules and forms, governance, actuarial services, selection and monitoring of Group B Carriers, monitoring of Group A Carriers, assignment of employers to carriers, dispute resolution and the management of interstate assignments.

All insurance carriers licensed to write workers' compensation insurance in State are required by State law to participate in the Plan with respect to policies that are incepted from Month 1, Year. An insurer can participate as a Group A, Group B or Group C carrier. (All Group B Carriers are also Group C Carriers.) Employers unable to obtain workers compensation insurance coverage through ordinary methods, who

together form the residual market, may apply to the Plan for coverage. Insurers choosing to be Group A Carriers provide coverage directly to their pro-rata shares of the residual market based on the premiums they write in the voluntary market, and in doing so, accept the resulting financial consequences. The Group B Carriers are chosen through a competitive bid process to provide coverage to the residual market that is not written by the Group A Carriers. Together, under the Plan, the Group A and Group B Carriers underwrite the entire residual market in State. Policy coverage with respect to the risks they underwrite is generally for a Plan Period unless rewritten to a short term policy for lapsed coverage.

The Plan operates, in part, through the Reinsurance Mechanism. Pursuant to that Mechanism, the Group B Carriers cede 100% of their collected premiums, less a fee, and 100% of their losses, allocated loss adjustment expenses, and premium collection expenses (Expenses), to the Plan. Losses are defined as payments the Group B Carriers are required to make to eligible insureds under the policies. The Plan will pay the Group B Carriers for their losses, allocated loss adjustment expenses, and Expenses (the Collective Retention Amount) up to the point where the Plan incurs a Deficit for a Plan Period. The Plan incurs a Deficit when the amount of the Plan's losses paid, allocated loss adjustment expenses, servicing carrier fees, administrative fees, taxes, assessments and all other Plan expenses paid exceeds the amounts of premiums actually received by the Plan, the Group B carriers and/or Administrator, net of any return premiums, plus the amount of investment income earned on invested assets.

The Plan will assess the Group C carriers an amount equal to the Excess Amount. The Excess Amount is an amount equal to the sum of all losses paid, Expenses paid, and Administration Expenses, in excess of the Collective Retention Amount. As a condition to holding its certificate of authority to transact workers' compensation insurance business in State, each Group C Carrier is responsible for paying its pro-rata share of the Excess Amount. That share is based on the premiums it wrote in the State voluntary market during the relevant Plan Period. The pro-rata shares are recalculated upon the determination by the Administrator, with the approval of the Commissioner, that any Group C carrier is unable to pay its pro-rata share due to a default of its obligations under the arrangement, whether voluntarily or by reason of the carrier's placement in any receivership, liquidation, rehabilitation or other statutory insolvency proceeding. The effect of this arrangement is to allocate, on a pro-rata basis, the Excess Amount to the Group C Carriers with respect to policies issued during a Plan Period, and to provide those Carriers are effectively, jointly liable for that Deficit .

Administrator is to apprise the Department on a quarterly basis of its actuarial estimate of the likelihood of a Deficit and of the amount thereof. Such estimates are to be determined by an evaluation procedure approved by the Department. If there is a projected Deficit, Administrator is also to provide the Department with projections as to when assessments are to begin. Upon receipt of a notice of assessment to pay its pro-rata share of the Excess Amount, each Group C Carrier is required to remit its payment

promptly. If a Group C Carrier fails to pay its pro-rata share, whether voluntarily or by reason of its placement in any receivership, liquidation, rehabilitation or other statutory insolvency proceeding, the delinquent Carrier's obligation is shared pro-rata by the other Group C Carriers.

If the Plan's combined results with respect to policies issued during a Plan Period result in a surplus[1], a Fund will be created. The distribution of any surplus will be as follows: (1) 60% to employers; (2) 15% to Group B Carriers; (3) 17.5% to Group C Carriers (not including those Group C Carriers that are also Group B Carriers); and, (4) 7.5% to Administrator.

Ruling Requested

The Plan requests a ruling that it is taxable as an insurance company under Internal Revenue Code § 831.

Applicable Law and Rationale

Whether an entity is an insurance company for federal income tax purposes depends on the character of the business it actually does in the taxable year. Section 1.831-3(a) of the regulations states that for purposes of §§ 831 and 832, the term "insurance company" means only those companies qualifying as insurance companies under former § 1.801-1(b) (now § 1.801-3(a)(1)) of the regulations.

Regulations § 1.801-3(a)(1) defines an "insurance company" as a company whose primary and predominant business activity during the taxable year is the issuing of insurance or annuity contracts or the reinsuring of risks underwritten by insurance companies.

Under § 7701(a)(3), an insurance company is treated as a corporation for federal tax purposes, regardless of whether it is classified as a corporation under state law. See Rev. Rul. 83-132, 1983-2 C.B. 270. Thus, the Code and regulations treat an entity primarily and predominantly engaged in the insurance business as an insurance company subject to tax as a corporation, regardless of the legal form of its organization. Sections 1.831-3 and 1.801-3(a)(1) of the regulations; Rev. Rul. 83-172, 1983-2 C.B. 106; Rev. Rul. 71-404, 1971-2 C.B. 260. See also, Bowers v. Lawyers Mortgage Co., 285 U.S. 182, 188 (1932); Commissioner v. W. H. Luguire Burial Ass'n Co., Inc., 102

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[1]A surplus is generated when the amount of losses paid, ALAE, Servicing Carrier Fees, taxes, assessments, incurred but not reported claims, administrative fees, and all other Plan expenses are less than premiums actually received by the Plan, the Group B carriers and/or Administrator, net of any return premiums, plus the amount of investment income earned on invested assets. The Surplus calculation combines the results of the Plan and the Class C Carriers.

F.2d 89, 90 (5th Cir. 1939).

Neither the Code nor the regulations thereunder define the terms “insurance” or “insurance contract.” The accepted definition of “insurance” for federal income tax purposes is found in Helvering v. LeGierse, 312 U.S. 531 (1941) in which the Supreme Court stated that, “[h]istorically and commonly insurance involves risk shifting and risk distributing.” Id. at 539. Case law has defined an insurance contract as, “a contract whereby, for an adequate consideration, one party undertakes to indemnify another against loss arising from certain specified contingencies or perils . . . . [I]t is contractual security against possible anticipated loss.” Epmeier v. United States, 199 F.2d 508, 509-10 (7th Cir. 1952). In addition, the risk transferred must be risk of economic loss. Allied Fidelity Corp. v. Commissioner, 66 T.C. 1068 (1976), aff’d, 572 F.2d 1190 (7th Cir. 1978), cert. denied, 439 U.S. 835 (1978).

Risk shifting occurs when a person facing the possibility of an economic loss transfers some or all of the financial consequences of the loss to the insurer. If the insured has shifted its risk to the insurer, then a loss by the insured does not affect the insured because the loss is offset by the insurance proceeds. See Rev. Rul. 92-93, 1992-2 C.B. 45 (permitting a parent company to deduct the premiums paid to the insurance subsidiary for group-term life insurance on an employee of the parent.)

Risk distribution incorporates the statistical phenomenon known as the law of large numbers. Clougherty Packing Co. v. Commissioner, 811 F.2d 1297, 1300 (9th Cir. 1987). When additional statistically independent risk exposures are insured, an insurance company’s potential total loss increases, as does the uncertainty regarding the amount of that loss. As uncertainty regarding the company’s total loss increases, however, there is an increase in the predictability of the insurance company’s average loss (total loss divided by the number of exposure units). That is, when the sample number increases, the probability density function of the average loss tends to be more concentrated around the mean. Due to this increase in predictability, there is a downward trend in the amount of capital a company needs per risk unit to remain at a given level of solvency. See Rev. Rul. 89-61, 1989-1 C.B. 75.

In Rev. Rul. 71-155, 1971-1 C.B. 152, a nonprofit association was composed of licensed insurance companies that made insurance available to persons in high risk categories. Those persons were not otherwise able to obtain insurance. The insurance policies were issued directly by members of the association, and the entire risk of loss on a particular policy was borne by the member that issued it. The ruling concludes that the association was a trade association, holding implicitly that the association itself was not engaged in the insurance business. Unlike the Plan, the organization described in Rev. Rul. 71-55 did not assume any insurance risk, and therefore was not itself engaged in the insurance business.

The Plan does not act simply as an agent of the Group C carriers. If a Group C Carrier fails to pay its pro-rata share of any deficit, the deficiency is shared pro-rata by

the other Group C carriers. Further, if a Group C carrier becomes insolvent, its liability is apportioned among the remaining Group C carriers. The Plan will reinsure policies written by the Group B Carriers, receiving on a monthly basis the premiums received by those carriers, less a fee, and less the losses they pay. The Plan is thus responsible for payments of all claims on the policies it reinsures. To the extent the Plan's required payments exceed the premiums for the provided coverage and the investment income thereon, less its expenses, the Group C Carriers in State will be assessed an Excess Amount. Nonetheless, the Plan itself is effectively entitled to the premiums paid by the employers in the residual market that are assigned to the Group B Carriers, and is liable for the losses incurred by those employers. Accordingly, we conclude that the Plan's primary business is the insurance business and that it is an insurance company for tax purposes. Cf., Rev. Rul. 81-174, 1981-1 C.B. 335, and Rev. Rul. 81-175, 1981-1 C.B. 337.

Except as specifically set forth above, no opinion is expressed regarding the Plan's status or the tax character of the arrangements described herein. Specifically, no opinion is expressed regarding the tax character of any surplus distributions by the Plan, or of any payments of Excess Amounts. Nor is any opinion expressed regarding whether the Plan is an organization described in § 501(c)(27).

In accordance with the Power of Attorney on file with this office, a copy of this letter is being sent to Plan.

Sincerely,

Assistant Chief Counsel
(Financial Institutions and Products)

By: (Signed by) Mark Smith
Mark Smith
Chief, Branch 4