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LETTER TO THE EDITOR

Dear Mr. King,

The article, "Is Homogeneity Required to Qualify as Insurance?" by Peter H. Winslow, Susan J. Hotine and Gregory K. Oyler, appeared in Vol. 3 Issue 3 September 2007 of *TAXING TIMES*. The article states that, "The importance of homogeneity is unclear"… At the end was the "***Editor's Note:*** Can any readers shine some light on this question?"

For the last 10 years, I served as the technical advisor for Captive and Offshore Insurance Transactions (COIT). My role was to provide advice to other IRS agents on insurance issues. Having recently retired from the IRS, I would like to share my thoughts on the significance of homogeneity.

In several Revenue Rulings evaluating whether risk distribution exists, the IRS stated that the risks were homogeneous. However, I believe that was done to exclude homogeneity as a factor in those rulings. The article in the September 2007 edition of *TAXING TIMES* refers to private letter rulings (PLR) which, though not binding, may give insight into the thinking of IRS attorneys. The article criticizes PLR 200715012, but this PLR does not necessarily express the views of IRS Chief Counsel (Counsel). While normally a PLR is written by Counsel, I recognize PLR 200715012 as the Tax Exempt Agent's Examination Report.

The official position of the IRS is expressed by Counsel. Despite having received comments in response to Notice 2005-40, Counsel has not taken a position on the significance of homogeneity. (*See* ILM 200849013). Pending such guidance, revenue agents have to make their own judgment.

As the article states, risk distribution is required by the Tax Court for insurance. Homogeneity is one of the three components of risk distribution of exposures, as opposed to distribution of premiums. The function of grouping risk with similar characteristics is to increase the predictability of losses for purposes of setting unpaid loss reserves; for determining the amount to be charged as premiums and as a corollary for determining the amount of surplus needed to assume such risk. To me the grouping for loss reserves follows the grouping for setting premiums. On the questions of what risks have sufficiently similar characteristics to be grouped together, I think the IRS should follow the industry, so long as the purpose of such grouping is to increase predictability of expected losses. Homogeneity can be compared to the stratification of a population in statistical sampling. It reduces the number of exposures necessary to achieve reasonably accurate results.

Commercial carriers have adequate risk distribution for prudent business reasons. Consequently, **Homogeneity is an issue for captives and other closely held insurance companies (CHIC).** It comes up in two contexts. The first is where, for example, the Captive assumes from brother/sister corporations the risks for a fleet of automobiles and two corporate aircrafts. The argument is that both are liability insurance, but the assumption of aircraft liability does nothing to increase the predictability of the auto liability or *vice versa*. In fact predictability is decreased. A premium to surplus ratio of three to one is a rule of thumb, albeit crude. Under that formula the auto liability policy requires surplus equal to one third of the auto liability premium plus the policy limits on the two aircraft policies, since they are unpredictable. The second context in which the issue arises is when a parent needs unrelated risk in its Captive in order to be able to satisfy the risk transfer requirement for insurance between a parent and its subsidiary. The assumption of unrelated risk in a different line of business from the related risk does not increase the predictability of the risks in either line. However, if the risks in each line are reasonably predictable, we need to shift the focus from distribution of exposure units to distribution of a pool of premiums. When the Tax Court analyzed whether a deduction was allowable for parent risk transferred to its subsidiary, it focused on whether risk was distributed among premiums from different policyholders, not on the number of exposures. When unrelated premiums are needed to pay for related losses the court held there was risk distribution and concluded that there must have been risk transfer. However, if one assumes an efficient market, then the loss cost premium on the unrelated risk line of business approaches actual unrelated risk losses, with little left over to pay for related losses. In contrast, if the unrelated risks are in the same line of business, then all such loss cost premiums are needed to pay for both related and unrelated risks. This is an area which needs further development, not from an actuarial point of view, but from a legal point of view. As the COIT technical advisor, I participated on tax panels at many captive insurance conferences. Currently, risks related to employee benefits are promoted as a source of unrelated risk for Captives. Part of my role at such conferences was to wave a cautionary yellow flag, as this issue has yet to be addressed by Counsel, or the courts.

Some argue distribution from writing multiple lines of insurance is superior to writing homogeneous risk, because the lines are not correlated. That may be true for the same reason that it is prudent to diversify a portfolio with stocks and bonds of different classes. The portfolio effect of stability of value is prudent, but it seems to me that it is a different concept from risk distribution. Risk distribution is not about stability of surplus; rather its focus is predictability of expected losses. I would argue both are valid concepts, but the portfolio effect is not risk distribution.

Risk distribution is a requirement for insurance as commonly understood. If a unique exposure is insured there is no risk distribution in terms of exposure units. However, if over half of the company's business activity is issuing policies that have risk distribution, then the company is an insurance company. The unique exposure simply increases the need for capital. In addition other forms of distribution may satisfy the fundamental principle of insurance that **the many pay for the few**. A single exposure may be assumed by bondholders in a special purpose vehicle (SPV) issuing a CAT bond. Typically such SPV would not qualify as an insurance company, because the contracts are derivative contracts as opposed to indemnity contracts. This is due to the need of bondholders for a prompt determination of loss. If the contract is an indemnity contract and thus responds only to actual losses, I think it may be accepted as insurance, so long as the risk is spread (distributed) among a substantial number of bondholders. This has been referred to as vertical distribution in contrast to the horizontal distribution of common insurance. Normally, as stated in PLR 9250021, claims are paid from premiums and investment income, the Service has yet to address the situation where the intended source of loss payment is capital instead of premium.

In conclusion, homogeneity is a CHIC issue. The IRS has not taken an authoritative position. It is my view that to achieve risk transfer from a parent to its subsidiary, the assumption of unrelated risk should be in the same line of business. The portfolio effect of multiple lines is not risk distribution.

Captives are a vehicle for formal risk retention within an affiliated group. It is not surprising that much of the controversy surrounding what is insurance, including the significance of homogeneity, flows from Captives as opposed to commercial carriers. ◀

Sincerely,
Timothy K. Collins