The Law of Anomalous Numbers: 2021 Brings a Plethora of US Insurance Tax Developments

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The Law of Anomalous Numbers, also known as Benford's Law, seeks to explain why the leading digits in any numerical distribution skew low. In a uniform distribution, each number (ignoring zero) has an 11.1% chance of being present. But that is not the way it works out in real life, as the number one has up to a 30% chance of being the leading digit in any arbitrary integer base. The number two has an 18% chance of being the leading digit, and so on. Thus, if the Law of Anomalous Numbers applied to IRS guidance, the number of insurance tax releases in any given year would be small. Lucky for us, though, in early 2021, the Internal Revenue Service ("IRS") and the Tax Court bucked Benford's Law and released a large number of insurance tax items. The subject matter of the guidance spans a variety of topics, including (i) the qualification of certain modified co-insurance agreements as reinsurance, (ii) an analysis of certain aspects of the base erosion anti-abuse tax (the "BEAT") for a domestic entity switching reinsurance counterparties, (iii) whether a micro-captive arrangement constituted "insurance" for US federal income tax purposes and (iv) the taxation of certain annuity advisor fees under the terms of a variable annuity contract.

I. PLR 202109005: Related-Party Risk Assumption Agreements Qualify as Reinsurance

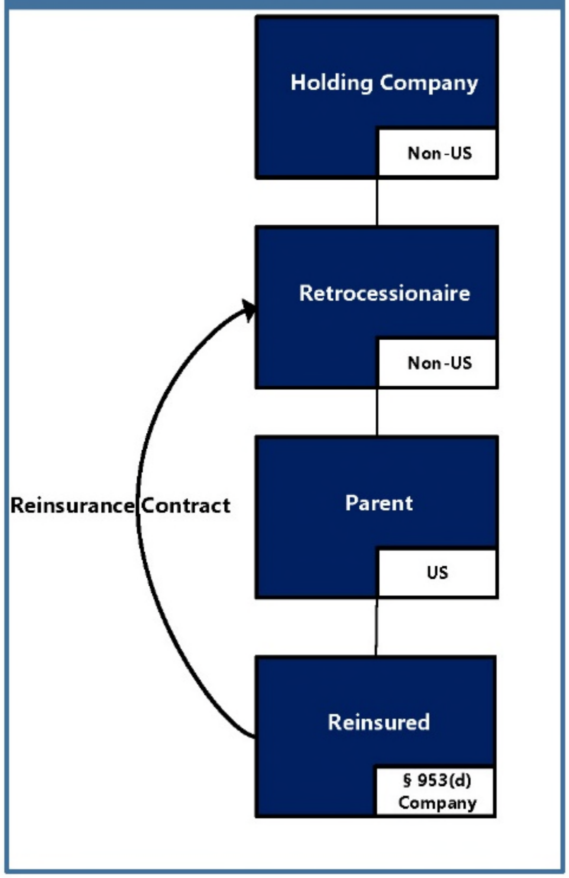
PLR 202109005 holds (but with scant discussion) that a reinsurance contract of related-party risk (stemming from diversified third-party risk) constitutes "insurance" for US federal income tax purposes, even when the insured must step up its premium payments to reimburse the insurer for sustained losses. The amount of loss and premiums are not specified, however, making it difficult to determine the actual amount of loss borne by the risk-assuming party. It is also a straightforward application of the position of the IRS as expressed in Revenue Ruling 2009-26: A taxpayer is permitted to determine whether there has been risk distribution and shifting on a look-through basis when the risk has already been aggregated by an affiliate. The ruling helpfully holds (but with scant discussion) that a reinsurance contract of related-party risk (stemming from diversified third-party risk) constitutes "insurance" for US federal income tax purposes.

In the ruling, a non-US corporation regulated as an insurance company ("Retrocessionare") owned a domestic corporation ("Parent"). Retrocessionare itself is owned by a non-US publicly traded insurance holding company. Parent owns all of the stock of a non-US reinsurance company, acting as reinsurer, that elected to be treated as a domestic corporation under Code § 953(d) ("Reinsured").

Reinsured is regulated as an insurance company in its jurisdiction of formation. Reinsured entered into various reinsurance agreements under which it assumed the risk under deferred and immediate annuity contracts issued by, or in some cases reinsured by, Reinsured's affiliates. Reinsured then insures against its risk with Retrocessionare through a renewable modified co-insurance contract. (When a reinsurance company insures itself, the transaction is referred to as "retrocession," and the party assuming the reinsurance risk is referred to as the "retrocessionaire.") The co-insurance arrangement was subject to mandatory renewal if the Retrocessionaire's payments and payment obligations exceeded the premiums payable by the Reinsured. The Reinsured could be required to make additional payments to the Retrocessionaire under the co-insurance payments as well, raising an issue as to whether the Retrocessionaire truly bore risk. These payments likely would have been characterized as additional premiums payable to the Retrocessionaire. The payments under the co-insurance arrangement were determined by actuarial analysis.

The arrangement between the parties that is the subject of the ruling is set forth in Figure 1 below.

Figure 1



The parties sought a ruling that the co-insurance arrangements would be treated as insurance for federal income tax purposes. Our speculation is that Reinsured sought a ruling on this question due to the uncertainty as to whether there was risk shifting in this transaction due to the fact that premiums could be increased if the Retrocessionaire experienced losses. If the transaction failed to be treated as insurance, premiums paid to the Retrocessionaire could have been subjected to a 30% withholding tax instead of the much lighter excise tax on insurance premiums.

The IRS began its analysis with an overview of the guidance on what constitutes "insurance." As is oft-repeated by the IRS and the courts, the US tax law does not provide a definition of "insurance," but the Supreme Court has provided four key features for distinguishing insurance from other arrangements:

- **Traditional insurance.** An insurance arrangement is "insurance" in its commonly accepted sense, generally depending on whether the entity is organized, operated, and regulated as insurance company, has adequate capitalization, and receives reasonable arm's-length premiums, among other factors;[2]
- **Insurance risk.** The arrangement is over an "insurance risk";
- **Risk shifting.** The insurance risk is shifted from one party to the other in the arrangement; and
- **Risk distribution.** The party insures the risk pools and distributes that risk.[3]

The Code specifies that "insurance" includes the issuance of annuity contracts.[4] PLR 202109005 concludes that the Contract constitutes reinsurance. Thus, the first two tests were clearly met.

The IRS has previously offered guidance on risk distribution for aggregated risks in Revenue Ruling 2009-26.[5] There, through a single reinsurance contract, a corporation reinsured the risk to another insurance company of 90% of all losses on insurance contracts with 10,000 unrelated policyholders.

The Revenue Ruling holds that despite the reinsurer entering into only one contract, because the risks of each original policyholder were distributed among the pool of policyholders, the reinsurer's risk was distributed through the single contract. But this look-through rule requires that there be risk diversification in the original transaction. In Revenue Ruling 2005-40, the IRS held that a purported insurance arrangement involving an issuer who contracts with only one policyholder does not qualify as insurance contracts because issuer did not distribute the risk.[6] PLR 202109005 does not specify the number of annuity policies underlying the Contract, it appears to be substantial.

II. PLR 202109001: Substituting Related-Party Reinsurers Does Not Trigger BEAT Payment

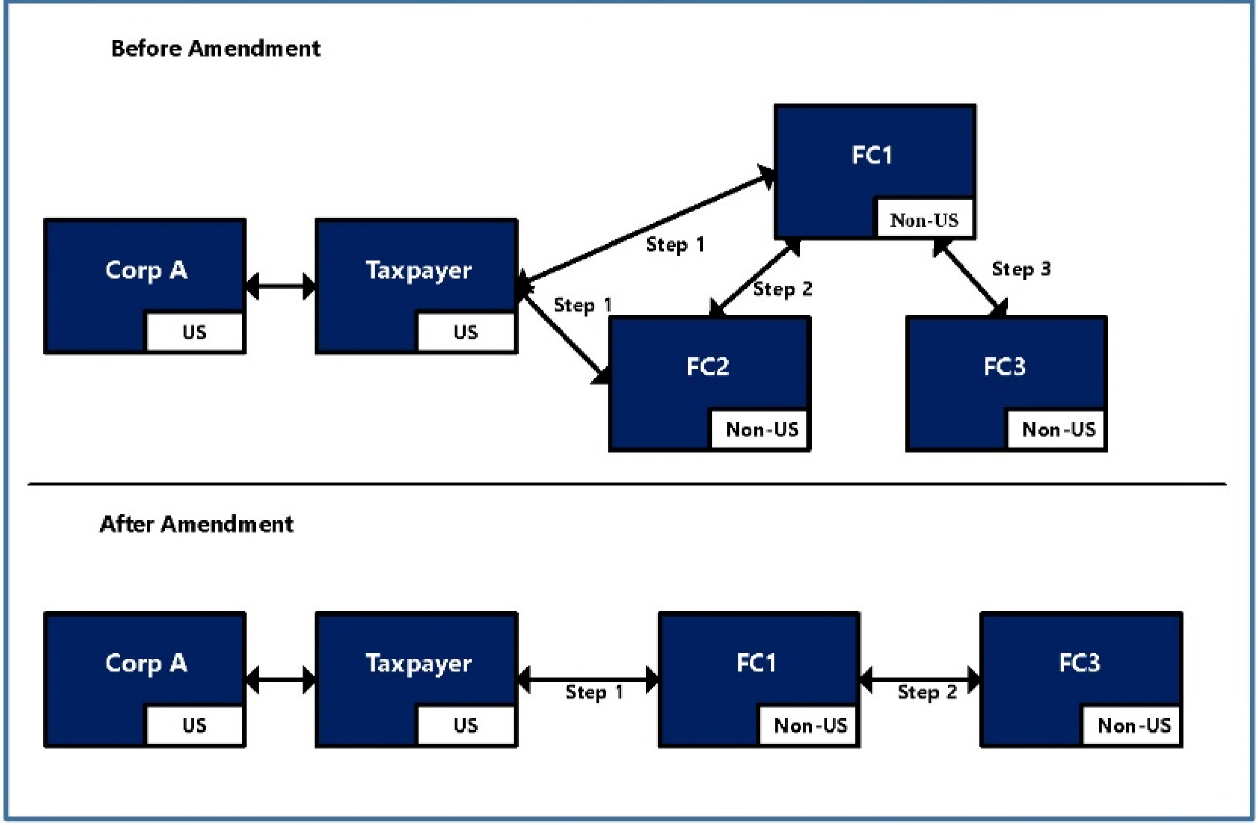
The BEAT functions as an alternative minimum tax in that specified taxpayers must make a parallel calculation to their regular tax liability and, to the extent such amount is greater than the taxpayer's regular tax liability, the BEAT imposes tax equal to the excess of the BEAT liability over the regular tax liability. At the heart of the BEAT calculation is the concept of a base erosion payment and, for each type of base erosion payment, the corresponding base erosion tax benefit. These concepts determine whether specified taxpayers are subject to BEAT, and if so, the amount of the BEAT liability. There are four types of base erosion payments enumerated in the statute.[7] One type of base erosion payment is an amount paid or accrued by the taxpayer to a foreign person for reinsurance payments taken into account under Code § 803(a)(1)(B) or Code § 832(b)(4)(A) (in which case the base erosion tax benefits are the reduction to gross income and the deduction provided for in such sections).

The BEAT applies only to taxpayers that are corporations (other than regulated investment companies, real estate investment trusts, or S corporations) that have average annual gross receipts of at least $500 million over a three-year period and, have a base erosion percentage of at least 3% (or, if they are a domestic bank, the base erosion percentage during the taxable year is at least 2%).

The BEAT liability, if any, is calculated by adding back to taxable income a taxpayer's base erosion tax benefits, plus the base erosion percentage of the taxpayer's post-2017 net operating loss deductions for the taxable year. The result, referred to as "modified taxable income," is then multiplied by an applicable tax rate. For tax years 2019 through 2025, the applicable tax rate is 10% and after 2025, the rate is 12.5%. (These rates are increased by 1% for US banks.) As stated above, if the BEAT exceeds the regular tax liability reduced by certain tax credits, the taxpayer will owe the BEAT amount.

In PLR 202109001, the taxpayer, a domestic corporation that was part of an affiliated group filing a consolidated federal income tax return, reinsured risk under certain insurance policies that it had written with another member of the affiliated group ("Corp A"). The taxpayer ceded a portion of this risk to its indirect non-US owner, a non-US corporation ("FC1"). The taxpayer also ceded a portion of this risk to an indirect non-US subsidiary of FC1 ("FC2"), which ceded the risk to FC1. FC1 also ceded a portion of the Corp A risks to another non-US subsidiary ("FC3"). To reduce operational complexity and administrative burden, the parties desired to remove intervening step 1 involved FC2 in transferring the Corp A risks from Taxpayer to FC1. Diagrammatically, the arrangements were as follows:

Figure 2



The issue appeared to be whether the substitution of FC1 for FC2 triggered a sale or exchange of the ceding agreement by the Taxpayer. *See* Rev. Rul. 90-109, 1990-2 CB 191 (change of insured triggered gain or loss inherent in an insurance contract); *Estate of McKelvey v. Comm'r*, 906 F3d 26 (2d Cir. 2018) (extension of variable prepaid forward contract triggered a sale or exchange of the contract). The IRS noted that the assumption by FC1 is an assumption reinsurance transaction within the meaning of Treasury Regulation § 1.809-5(a)(7)(ii).[8] Case law states that an assumption reinsurance transaction is treated as a sale by the ceding company to the reinsuring company.[9] If this treatment governed the consequences for the taxpayer, and the taxpayer had a loss on such sale, the loss could have been treated as a base erosion payment.

PLR 202109001, citing Revenue Ruling 82-122, 1982-1 CB 80, concludes that the substitution of FC1 for FC2 resulted in the sale of the contract. The IRS highlights that the premiums to be paid by the Taxpayer were unaltered by changing the counterparty. Because of this, the IRS concluded that any amount paid on the assumption should be between FC1 and FC2, not a premium or other deductible payment made by Taxpayer to a foreign affiliate that could give rise to a base erosion payment for purposes of the Taxpayer's BEAT calculation. In other words, from the perspective of the Taxpayer, the IRS essentially treated the substitution of reinsurers as a modification that was not material, given that the payments to be made by the Taxpayer did not change as a result of the substitution. The analysis of the IRS appears to dovetail with the rule in Treasury Regulation § 1.1001-3(e)(4)(iv). Under that regulation, a change in credit enhancement on a debt instrument triggers a sale or exchange only if there is a change in payment expectations. The authors also note that Treasury Regulation § 1.1001-4, relating the substitutions of counterparties on derivatives, reaches the same conclusion for the non-transferring party on those contracts when such contracts are transferred between dealers or clearinghouses.

III. *Caylor Land & Development, Inc. v. Comm'r*, TC Mem. 2021-30 (March 10, 2021)

"Micro-captive" insurance transactions can offer substantial tax benefits. On one hand, the payment of the premiums can be deductible to the insured. On the other hand, if the net written premiums received by the insurance company do not exceed $2.2 million, the insurance company does not pay tax on the premium income.[10] The IRS has taken a dim view of small insurance company transactions in which the insurance company is related to the companies from which it has assumed risk. In Notice 2016-66, modified by Notice 2017-8, 2017-3 IRB 423, the IRS identified certain micro-captive insurance transactions as "transactions of interest."[11] The IRS has been on a tear litigating, and winning, decisions against micro-captive transactions. *See Avrahami v. Comm'r*, 149 T.C. No. 7 (2017); *Reserve Mechanical Corp. v. Comm'r*, TC Mem. 2018-86; *Syzygy Insurance Co. v. Comm'r*, TC Mem. 2019-34. On April 9, 2021, the IRS announced that it had formed 12 audit teams dedicated solely to challenging micro-captive transactions.[12] Previously, it had offered a limited time settlement to taxpayers who participated in these transactions.[13]

The IRS's string of victories against micro-captive insurers continued into early 2021 with strong decision in the Tax Court in *Caylor Land & Development, Inc. v. Commissioner*.[14]

In *Caylor*, a family owned a variety of entities in the business of commercial construction. The Caylors historically purchased third-party insurance (and continued to do so during the years at issue) but decided to also form a captive insurance company in Anguilla with an election for the company to be a Code § 953(d) company. The premiums deducted by the Caylor entities and paid to the captive were $1.2 million in each year covered by the decision (the then maximum amount permissible for the captive to pay no tax on premiums received). Although twelve Caylor entities paid premiums to the captive, the Tax Court observed that one Caylor entity, Caylor Land, was the revenue generator for the family of affiliates, and all funds to pay the insurance premiums ultimately flowed from Caylor Land. The premiums in each year were paid before contracts for each year outlining the insurance policies were drafted. During the three year period of coverage, the captive paid four claims that amounted to $43,000. The captive paid the claims without receiving requested information about the claims, an action which the court noted is not standard practice for an insurance company. Across the entities, the insurance covered 34 different exposures.

The Tax Court begins its analysis with the four *Le Gierse* factors discussed above, concluding that the arrangement did not satisfy the requirement that the captive distribute its risk and the requirement that the arrangement was insurance in its commonly accepted sense. On risk distribution, the Tax Court examined whether the captive distributed the risk among a sufficient number of unrelated risks for the law of large numbers to predict expected losses (as in other Tax Court precedent). In finding the captive did not, the Tax Court first emphasized in cases where a captive arrangement was respected, captives insured risks in the thousands.[15] This leaves a grey area between the thirty-four independent exposures assumed by the captive in *Caylor* and the thousands accepted as satisfying the law of large numbers in the Tax Court's other precedents. Second, the Tax Court reasoned that risk distribution is better supported where the risks are more independent than under the facts of *Caylor*, where all risks insured by the captive were related to the real estate business in a single geographic area.

Although in Revenue Ruling 2005-40, the IRS interpreted risk distribution to require both many insureds and many risks, the Tax Court has been less clear. Both *Rent-A-Center* and at least one other case presented instances of many risks but only one or two insureds. In *Avrahami*, the court said without any analysis (or mention of *Rent-A-Center*) that three insureds are insufficient. The court in

Caylor refrains from clearly adopting the IRS's requirement of many insureds but satisfies itself by saying the law of large numbers means more than the 30 or so risks involved in that caser. We are still waiting for the Tax Court to agree or disagree with whether the IRS's position in Revenue Ruling 2005-40 that 10,000 risks from only one customer does not accomplish risk distribution.

In finding that the captive arrangement in *Caylor* was not insurance in its commonly accepted sense, the Tax Court held that (a) the captive did not act as an insurance company and the Caylor entities did not act as insureds, since the parameters of a policy were not established for a taxable year until after premiums had been paid and claims were paid on the policies without the captive receiving requested information about the claims, and (b) the premiums paid to the captive were far in excess of any expected loss and were calculated by including an adjustment mechanism meant to reach the then-$1.2 million cap under Code § 831(b).

Since the Tax Court found that the captive arrangement was not insurance in the commonly accepted sense and that it lacked risk distribution, the Court held that the arrangement between the *Caylor* entities and the captive was not insurance. *Caylor* highlights some bad facts to watch out for when structuring a captive arrangement meant to be characterized as insurance.

IV. Annuity Adviser Fees Paid Net Not Taxable to the Annuity Owner

One of the tax benefits of whole life insurance and variable annuities (together, variable contracts) is that the investment component of the contracts can be taxed in the same manner as death benefits and periodic payments. In other words, variable contracts offer investment returns on these products that are taxed much more favorably than if the insured or annuitant held the same investments outside of an insurance product. In order for the investment component of a variable contract to receive this favorable tax regime, the insurance contract must meet certain diversification and investor control requirements. The diversification requirements are spelled out in Treasury Regulation § 1.817-5. The IRS has spelled out the investor control requirements, however, through a series of rulings and other authorities. *See Webber v. Commissioner*, 144 TC 324 (2015) (IRS position on investor control adopted by Tax Court).

Traditionally, the IRS interpreted the investor control requirement in a rigid manner. In Rev. Rul. 77-85, 1977-1 C.B. 12, the IRS concluded that an individual purchaser of a variable annuity contract who retained "significant incidents of ownership" over the assets held in the custodial account was treated as the owner of those assets for federal income tax purposes. In Rev. Rul. 80-274, 1980-2 C.B. 27, the IRS applied Rev. Rul. 77-85 to conclude that if a purchaser of an annuity contract could select and control the certificates of deposit supporting the contract, then the purchaser was considered the owner of the certificates of deposit for federal income tax purposes. Similarly, in Rev. Rul. 81-225, 1981-2 C.B. 12, which was clarified and amplified by Rev. Rul. 2003-92, 2003-2 C.B. 350, the IRS concluded that investments in mutual fund shares that funded annuity contracts were considered to be sub-accounts. Each sub-account invested in interests in a partnership. The IRS held that in situations in which the sub-accounts held interests in partnerships available for purchase other than by purchasers of annuity or variable contracts from an insurance company, the contract-holder was the owner of the interests in the partnerships held by the sub-accounts for federal income tax purposes.

In recent years, the IRS has relented on this rigid approach and has been issuing private letter rulings to taxpayers that variable contract holders would not be treated as the owner of the underlying investments where the underlying investments can be chosen by a licensed investment advisor chosen by the insured. The rulings even permit the investment advisor to be affiliated with the issuer of the variable contract. The issuing insurer will pay fees to the adviser for investment advice that the adviser provides to the variable contract owner with respect to the variable contract. The variable contracts offered numerous investment options for the insured or annuitant where the advisor, in consultation with the insured, allocated the contract corpus among these investment choices. The IRS recently issued a number of private rulings holding that these advisory schemes did not violate the investor control requirement. *See e.g*., PLR 202104001, PLR 20205004, PLR 20205006, PLR 202024008, and more.

In March and April 2021, the IRS released several private letter rulings holding that annuity advisor fees under a variable annuity contract which were deducted from the cash value of the annuity contract for investment advisory services rendered to the insured under variable contracts did not constitute deemed distributions to the contract owner.[16] As part of the contract, the Adviser provided ongoing investment advice to contract owners in exchange for a fee. Rather than charge the owner a fee directly or from any distribution from the variable contract to the owner, the Adviser was paid by the insurer from the cash value of the annuity contract. Economically, it could have been viewed as though the owner was distributed cash which was then paid to the Adviser for the adviser's services under the contract.

The IRS held the amounts withdrawn as advisory fees should not be treated as an "amount received" by the beneficial owner of the contract. The ruling concludes that the beneficial owner should not treat the advisory fees as an amount received from the annuity contract. Taking an "entity-level" approach to the fees, the rulings find that the fees are an expense of the investment contract, not the beneficial owner, because (a) the contract was designed to depend on the ongoing investment advice, (b) the fees will only be used to pay for advisory services under the contract and will not be consideration for any other service, and (c) the fees were reasonable at 1.5%. The structure of this transaction effectively allows the investor to deduct the cost of the investment manager's fees despite the 2% floor and the suspension of Code § 67 deductions subject to the 2% floor through 2025.

Although the PLRs are noticeably silent on the investor control requirement, they assume without discussion that the arrangements will not violate such requirement. The advisor works directly with the variable contract owner to determine the allocation among investment strategies available within the segregated accounts held by the insurance company that are dedicated to the variable contract and are paid by the insurer. Under prior IRS guidance, variable contract owners would have been concerned that this type of arrangement would have caused the contract owner to have control over the assets held by the insurer. The fact that the IRS is now issuing rulings on this structure is likely to further enhance the market for variable contracts.

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2 *See*, *e.g.*, *Avrahami v. Commissioner*, 149 T.C. 144 (2017).

3 *Helvering v. E. Le Gierse*, 312 U.S. 351 (1941)

4 *See* Code section 816(a), where a life insurance company is defined as an insurance company which is engaged in the business of issuing life insurance and annuity contracts with corresponding reserves in excess of 50% of its total reserves.

5 Rev. Rul. 2009-26, 2009-39 IRB 366 (2009).

6 Rev. Rul. 2005-40, 2005-2 CB 4 (2005).

7 The term "base erosion tax benefit" also includes amounts paid to related foreign persons to acquire depreciable property (in which case the base erosion tax benefit is the depreciation deductions), amounts paid to related foreign persons for reinsurance payments taken into account under Code § 803(a)(1)(B) or Code § 832(b)(4)(A) (in which case the base erosion tax benefits are the reduction to gross income and the deduction provided for in such sections), and amounts paid or accrued by a taxpayer that result in reductions in gross receipts if the payment is to a related "surrogate foreign corporation" or to a foreign person in the same expanded affiliated group as the surrogate foreign corporation (in which case the base erosion tax benefit is the reduction in gross receipts).

8 Under that regulation, assumption reinsurance as an arrangement whereby another person (the reinsurer) becomes solely liable to the policyholders on the contracts transferred by the taxpayer (not including indemnity reinsurance or reinsurance ceded).

9 *Beneficial Life Ins. v. Commissioner*, 79 T.C. 627 (1982), *nonacq.* on other grounds, 1982-2 C.B. 1.

10 Code section 831(b)(1).

11 Notice 2016-66, 2016-47 IRC 745 (2016). A transaction of interest is a "reportable transaction," which generally requires all participants to the transaction (and their material advisers) to file forms with the IRS describing the transaction. A failure to properly report a transaction of interest results in penalties of up to $10,000 for natural persons and $50,000 for all other taxpayers. *See* Code section 6707A(b)(2)(B).

12 *See* IRS News Release, *IRS urges participants of abusive micro-captive insurance transactions arrangements to exit from arrangements* (IR-2021-82) (Apr. 9, 2021).

13 *See* Clock Ticking for Micro-Captives Considering IRS Settlement Offer (2) (Bloomberg News Sep. 17, 2019).

14 *Caylor Land & Development, Inc. et. al. v. Commissioner*, T.C.M. 2021-30 (March 10, 2021)

15 *See Harper Grp. v. Commissioner*, 96 T.C. 45 (1991), *aff'd* 979 F. 2d 1341 (9th Cir. 1992) (captive insured 7,500 customers covering more than 30,000 different shipments and 6,722 special cargo policies); *Rent-A-Center, Inc. v. Commissioner*, 142 T.C. 1 (2014) (captive insured three types of risks covering 14,000 employees, 7,000 vehicles, and 2,600 stores); and *R.V.I. Guar Co. v. Commissioner*, 145 T.C. 209 (2015) (captive insured one type of risk through 951 policies covering 714 insured parties with more than 754,000 passenger vehicles, 2,00 individual real-estate property, and 1.3 million commercial-equipment assets).

16 *See, e.g.*, PLR 202109002, PLR 202109003, PLR 202114005, and PLR 202114006.