INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

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CASE-MIS No.: TAM-144706-10

Director of Field Operations, East
LB:F:DFO:E

Taxpayer's Name:
Taxpayer's Address:

Taxpayer's Identification No
Year(s) Involved:
Date of Conference:

LEGEND:

Taxpayer:

Year 1:

B:

State:

Partnership:

ISSUE:

Whether a contract labeled " insurance" that "insures" against market decline is a contract of insurance for federal income tax purposes.

CONCLUSION:

A contract labeled " insurance" that “insures” against market decline is not a contract of insurance for federal income tax purposes.

FACTS:

For Year 1, Taxpayer filed as a domestic property and casualty insurance company joining an affiliated group of corporations filing a consolidated federal income tax return. During Year 1 and prior years, Taxpayer entered into contracts (the “contracts”), entitled " insurance policies,” with unrelated parties (the “protected parties”).[1] These contracts cover multiple classes of assets including passenger vehicles, commercial equipment, and commercial real estate that the protected parties leased to third parties (the “protected assets”). The length of the contracts differed, however, some contracts, such as contracts relating to commercial equipment and commercial real estate, could have a 10-25 year term. The contracts were issued in a form commonly accepted as insurance, they have standard policy provisions similar to insurance policies, and they require the protected party have an ownership interest in the underlying asset at the time the contract was entered into and throughout the term of the contract.

Under a contract, Taxpayer was obligated to pay a protected party the excess of the predicted residual value of the protected asset as set forth in the contract over the fair market value of the asset at the end of the lease term (the residual value payment). The fair market value of the protected asset at the end of the contract term was determined by the actual sales price, appraisal, or industry index, as specified in the contract. A protected party could elect to have the contract apply to a group of assets and provide that Taxpayer would be required to make a payment only if the total fair market value of the assets was less than the total predicted residual value of all the assets.

Taxpayer’s obligation to make a residual value payment matures at the end of the contract term. Fluctuations in the protected asset’s value during the term of the contract do not create a liability unless the decline is permanent. If Taxpayer pays a residual value payment, the agreement provides that the Taxpayer is either subrogated to the protected party’s rights with respect to the covered asset[2] or receives title to the covered asset. In consideration for its obligation under a contract, at the time the

[1] The TAM submission uses different terms to describe the transaction than are used in this Technical Advice Memorandum. For example, the payment to the Taxpayer is referred to as a premium. The submission makes clear that the use of these terms was not intended to convey the ordinary meaning of these terms or that the contracts were insurance contracts. To eliminate confusion, we use more neutral terms.

[2] As a practical matter, it is not clear how Taxpayer subrogation would work when there is only a decline in market value.

contract was signed, Taxpayer receives a payment. The parties agree that the payment relates to Taxpayer's obligation over the entire term of the contract.

The contract lists a number of factors that could impair the final value of a covered asset. These are merely examples, however. There is no requirement to demonstrate that a covered loss actually resulted from any of the listed factors. Moreover, the factors identified, such as an economic downturn or advances in technology, are risks of all commercial transactions. Exclusions set forth in the contracts include:

Before Taxpayer makes a residual value payment to a protected party, the request for payment is submitted to the Taxpayer's claims department to determine if the claim is covered by the contract. Taxpayer also verifies that the protected party has an ownership interest in the asset, and that all terms and conditions of the contract have been satisfied. Payment is made subject to all declarations, exclusions, and other terms and conditions of the policy.

Taxpayer files a National Association of Insurance Commissioners ("NAIC") annual statement and is regulated by State (Taxpayer's domicile) and all other jurisdictions in which it is licensed as an insurance company.

[3]

[3] Statement No. 133 standardizes the accounting treatment for derivative instruments by requiring all entities to report derivatives as assets and liabilities on the balance sheet at their fair values.

Attachment 1, Exhibit A[4] of Taxpayer's submission is a contract for a commercial real estate building between Taxpayer and Partnership. According to the Taxpayer's document entitled "Summary Description of Insurance Policy," (Attachment 2, Exhibit 1)[5], the protected party issued debt to purchase an asset to lease to a third party. The contract is intended to protect the holders of the debt, the "Loss Payees." By endorsement to the contract, the "Loss Payees" are defined as the holders of certificates issued by a trust that holds the protected party's note on the property. Because the focus of the contract's protection is on the Loss Payee, the contract defines the payment that would be required by the Taxpayer by reference to the outstanding principal and interest on the note.

[6]

[4] Electronically attached to submission materials as: "003_Attachment 1 – Exhibit A."

[5] Electronically attached to submission materials as: "009_Attachment 2 – Exhibit A1."

[6] Electronically attached to submission materials as:"006_Attachment 1 – Exhibit D (part 1)."

LAW AND ANALYSIS:

Neither the Internal Revenue Code nor the Income Tax Regulations define the terms "insurance" or "insurance contract." The standard for evaluating whether an arrangement constitutes insurance for federal tax purposes has evolved over the years and is, at best, a nonexclusive facts and circumstances analysis. Sears, Roebuck and Co. v. Commissioner, 972 F.2d 858, 861-64 (7th Cir. 1992). The most frequently cited opinion on the definition of insurance is Helvering v. LeGierse, 312 U.S. 531 (1941), in which the Court describes "insurance" as an arrangement involving risk-shifting and risk-distributing of an actual "insurance risk" at the time the transaction was executed. Cases analyzing "captive insurance" arrangements have described the concept of "insurance" for federal income tax purposes as containing three elements: (1) involvement of an insurance risk; (2) shifting and distributing of that risk; and (3) insurance in its commonly accepted sense. See e.g., AMERCO, Inc. v. Commissioner, 979 F.2d 162, 164-65 (9th Cir. 1992), aff'g. 96 T.C. 18 (1991). The test, however, is not a rigid three-prong test.

There is also no single definition of insurance for non-tax purposes. "[T]he subject has no useful, or fixed definition. There is neither a universally accepted definition or concept of 'insurance' nor a [sic] exclusive concept or definition that can be persuasively applied in insurance lawyering." 1 APPLEMAN ON INSURANCE 2d, § 1.3 (2005). While "it seems appropriate that any concept and meaning of insurance be sufficiently broad and flexible to meet the varying and innovative transactions which humankind perpetually produces," care must be used to describe insurance because "overbroad definitions are not useful and may cause many commercial relationships erroneously to constitute insurance." Id. Moreover, a state's determination of whether a product is insurance for state law purposes does not control whether the product is insurance for federal tax law. See AMERCO, 96 T.C. 18, 41 (1991). There is no need for parity between a state law definition and federal definition as the objective for state purposes is company solvency. Solvency is not a concern for determining whether an arrangement qualifies as insurance for federal income tax purposes.

In the literature, insurance has been described:

> [i]n practice, insurance is available only when the Law of Large Numbers is observed. The law requires that the risks insured must be both large in number and independent of one another, like successive deals in a game of poker.
>
> 'Independent' means several things: it means that the cause of a fire, for example, must be independent of the actions of the policyholder. It also means that the risks insured must not be interrelated, like the probable move of any one stock at a time when the whole stock market is taking a nose dive, or the destruction caused by a war. Finally, it means that insurance will be available only when there is a rational way to calculate the odds of loss, a restriction that rules out insurance that a new dress style will be a smashing success or that the nation will be at war at some point in the next ten years.
>
> Consequently, the number of risks that can be insured against is far smaller than the number of risks we take in the course of a lifetime.

Peter L. Bernstein, AGAINST THE GODS THE REMARKABLE STORY OF RISK 204 (1998).

In modeling insurance risk,

> …. at the start of a period of insurance cover the insurer does not know how many claims will occur, and, if claims do occur, what the amount of these claims will be. It is therefore necessary to construct a model that takes account of these two sources of variability.

David C. M. Dickson, INSURANCE RISK AND RUIN 52 (2005).[7]

We have examined the substance of the arrangement labeled " insurance" and conclude that the contract does not satisfy the three-factor test defining insurance set forth in case law. The arrangement is not insurance because it lacks insurance risk, it is not insurance in the commonly accepted sense, and it lacks risk distribution.

Not all contracts that transfer risk are insurance policies even where the primary purpose of the contract is to transfer risk. For example, a contract that protects against the failure to achieve a desired investment return protects against investment risk, not insurance risk. LeGierse, 312 U.S. at 542 (the risk must not be merely an investment risk); Securities and Exchange Commission v. United Benefit Life Insurance Co., 387 U.S. 202, 211 (1967) (the transfer of an investment risk cannot by itself create insurance). See also, Rev. Rul. 89-96, 1989-2 C.B. 114 (risks transferred were in the nature of investment risk, not insurance risk); Rev. Rul. 68-27, 1968-1 C.B. 315 (although an element of risk existed, it was predominantly a normal business risk of an organization engaged in furnishing medical services on a fixed price basis rather than an insurance risk) and Rev. Rul. 2007-47, 2007-30 I.R.B. 127 (the arrangement lacked the requisite insurance risk to constitute insurance because the arrangement lacked fortuity and the risk at issue was akin to the timing and investment risks of Rev. Rul. 89-96).

The line between investment risk and insurance risk, however, is pliable.

> [t]he finance and insurance industries have much in common. The different tools these industries provide their customers for managing financial insurable risks rely on the same two fundamental concepts: risk pooling and risk transfer. Further, the valuation techniques in both financial and insurance markets are formally the same: the fair values of a security and an insurance policy are the discounted expected values of the cash flows they

[7] See also S. S. Huebner, Kenneth Black, Jr., and Bernard L. Webb, PROPERTY AND LIABILITY INSURANCE 4 (4th ed. 1996) ("The real contribution of insurance is due to a combination of a large number of separate risks into a group, thus making possible the 'substitution of certain for uncertain loss.' The larger the number of separate risks combined in a group, the less uncertainty there will be as to the amount of loss, since the law of averages will apply with greater precision; the less uncertainty of loss, the less money is necessary from the insured group to meet the losses of the few.").

> provide their owners. Scholars and practitioners recognize these commonalities. Not surprisingly the markets have converged recently; for example, some insurance companies offer mutual funds and life insurance tied to stock portfolios, and some banks sell annuities.

FINANCIAL ECONOMICS WITH APPLICATIONS TO INVESTMENTS, INSURANCE AND PENSIONS 1 (Harry H. Panier, ed., 2001).

Insurance risk requires a fortuitous event or hazard and not a mere timing or investment risk. A fortuitous event[8] (such as a fire or accident) is at the heart of any contract of insurance. See Commissioner v. Treganowan, 183 F.2d 288, 290-91 (2d Cir. 1950) (the risk must contemplate the fortuitous occurrence of a stated contingency not an expected event).

The contracts at issue contemplate a projected decline in value over the term of the contract and then provide protection against the actual value at the end of the contract being lower than that projected value. The contracts generally do not protect against damage to the particular asset.[9] Instead, the contracts protect against market forces that depress the value of the protected asset (and other similar assets) at the end of the term. At least some of the contracts have been used to ensure a sufficient stream of income at the end of the contract to meet debt service payments. Thus, it can be fairly concluded that the risk protected against is the risk that the protected party will receive less than its projected income from the protected asset at the end of the lease. We conclude that this type of risk is more akin to an investment risk than to an insurance risk.

Secondly, the arrangement is not insurance in its commonly accepted sense. The fact that other companies offer contracts similar to those at issue in this case does not change our conclusion. The phrase "insurance in its commonly accepted sense" does not mean that all products sold by

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[8] A happening that, because it occurs only by chance or accident, the parties could not reasonably have foreseen. Black's Law Dictionary, 725 (9th ed. 2009). See also, First Restatement of Contracts § 291, cmt. a (1932); American Law Institute, Restatement (Second) Contracts § 379, cmt. a (1981). See Generally, Jeffery W. Stempel, Stempel on Insurance Contracts, § 1.06A[4] (2007 Supp.) ("[I]n the past 20 years, a "modern" view of fortuity as a matter of law has emerged in United States courts, one that largely embraces the notions of fortuity held by the American Law Institute when it adopted the Restatement of Contracts, first in 1932 and again in the Second Restatement published in 1981.").

[9]

insurance companies are insurance policies. The tax treatment of a product at issue should be decided by legal relationships and not by the number of product sellers or the amount of product sales. To determine whether a legal relationship results in insurance, we compare the arrangement against known insurance products. As seen in our review of other insurance contracts below, a factor found in insurance contracts that weighs heavily in this case is that insurance policies protect against damage or impairment to an asset or income from an asset caused by a casualty event.

The contracts at issue have many features commonly found in insurance policies. For example, the contracts are issued in a form commonly accepted as insurance, they have provisions similar to insurance policies, and they require that the protected party retain an ownership interest in the covered asset. In addition, Taxpayer pays premium taxes on the payments it receives under the contracts . We nevertheless conclude, based on all the facts and circumstances, that the contracts are not insurance in its commonly accepted sense because they do not contemplate a casualty event.

Taxpayer's obligation does not arise because of an event that damages or impairs the protected asset or its income stream. The contracts explicitly limit Taxpayer's liability if there is damage or impairment to the asset commonly associated with a casualty event, such as:

The contracts ensure that the projected income from the sale of the assets will not be reduced because of market forces. The risk is the unexpected market forces, but the occurrence of these events is not the casualty event. Unfavorable market changes may occur during the term of the contract without creating any liability. The event that triggers Taxpayer's liability is the termination of the contract. We conclude that contract termination is not the type of event that gives rise to a casualty event.

While it is possible that there is a permanent decline in value of the protected asset during the term of the contract (e.g. technological obsolescence of the asset), we find that even in these cases, the policies are not insurance. Taxpayer's obligation to make a residual value payment does not require that there be a permanent decline in value. Moreover, even if there was an unforeseeable permanent decline in asset value during the term of the contract, it is irrelevant at what point it occurred; the protected party will not receive payment until the end of the contract term (possibly 25 years later) and only then to the extent that value is less than the predicted residual value. The significant mismatch between recovery under the contract and the decline creates a critical gap between the two events.

Taxpayer analogizes the contracts to particular insurance products to support its position. Each of these arrangements differ from the contracts at least because they involve a casualty event that impairs or damages the relevant asset. For example, Taxpayer refers to title insurance, surety insurance, life insurance, ocean marine fleet insurance, marine “total loss only” insurance, and underground storage tank liability insurance. Each of these types of insurance policies provides coverage following a casualty event in some form that causes a loss. While some of these insurance contracts support the notion that the event does not have to happen during the term of the policy, a casualty event and damage or impairment in some form is required. Taxpayer also points to event cancellation insurance, municipal bond insurance, and aggregate medical stop-loss insurance as instances in which the insurance company’s payment can occur much later than the loss event. Again, these contracts involve a casualty event (e.g., the incident that cancels the event). While there are insurance policies that may be influenced by a decline in asset value, the insurance company’s obligation under these policies still rests on a casualty event and the casualty must cause the decline in value. For example, while the decline in home value may impact whether a loss is claimed on mortgage guarantee insurance, the event that triggers the loss isn’t the decline in asset value; it is the failure of the mortgagor to pay. Similarly, lease guarantee insurance protects the income stream of the lessor but only from a casualty event—the failure to pay rent. The only product we are aware of that is comparable to residual value insurance and enjoys treatment as insurance for federal tax purposes is crop insurance, which was given insurance treatment in targeted legislation. Accordingly, we are not persuaded by the Taxpayer’s analogies.

Finally, we conclude that the agent's position on risk distribution finds more support in the facts than the Taxpayer's position. Taxpayer, in its submission, states that risk distribution relates to the pooling together of a large number of statistically independent risks. Taxpayer argues that risk distribution is achieved under its policies because Taxpayer insures a multitude of residual value risks of numerous unrelated insureds. Taxpayer provides examples, including the decision of an employer to vacate a building in one state as having no impact on the value of a vehicle in another state, and of the technological obsolescence of a type of airplane that does not impact the value of an office building or vehicle.[10] The Service's Examination Team states that the risks under the contracts are interdependent. In particular they argue that the

[10] Electronically attached to submission materials as: "001." Discussed at pgs. 12-13.

unemployment and depreciation rates are linked such that if unemployment is high, every vehicle in a given portfolio can have losses.[11]

The issue of risk distribution was considered in Rev. Rul. 60-275, 1960-2 C.B. 43. In that ruling, a number of “insureds” pooled their “premiums” for coverage of assets all subject to the same flood risk. The Service concluded that risk distribution was not present reasoning, in part, that a major flood would affect all properties involved because all properties were located in the same flood basin. The ruling stated that there was little likelihood that the subscribers would share any risk. Also of concern was the fact that the entities pooling their premiums were all significantly under-insured, implying that risk could not be shifted if the company could not pay claims.

The contracts protect against market forces that depress the value of the protected asset. As suggested in the actuarial review of the transaction, these market forces could impact all assets. If the market forces are significant, such as a sufficient unemployment rate, the value of most, if not all, protected assets could be depressed. Similarly, Taxpayer’s obligation may arise, for example, because unanticipated gas prices adversely impact the value of vehicles that are less fuel efficient. Because this risk is a market force impacting all assets, all vehicles of this type would be impacted, including protected assets of this type. As fuel prices increase, even fuel efficient vehicles may be impacted. Thus, there can be interdependence in the covered risks that affect the protected assets. While these factors can create an obligation only upon termination of the contract, which may occur on different dates, to the extent that the termination dates of the contracts are sufficiently close in time or that the contract applies to pools of assets, the interdependence of the risks supports the examining agent's position that there is no risk distribution.

To illustrate the “interdependency” concern, if an “insurer” has a portfolio of 100 cars subject to typical insurance risk (i.e., property/casualty insurance for accident, theft, etc.), perhaps 20 to 30 percent of these vehicles might suffer some type of perilous hazard in a given year. The ability of the insurer to predict the incidence of perilous events during a given period allows the insurer to estimate the amount of premiums needed to cover expected future losses. This estimation of future losses is possible because the insurer can predict (through the law of large numbers) the percentage of vehicles that likely will suffer a covered event. This process, in part, achieves risk distribution with the key element being the independence of the risk units at issue.

Using the same example in the residual value context produces a different result because the risks are interdependent. Again, if determining the residual value of a vehicle is based in large part on depreciation rates, then a sufficient rise in unemployment rates will more likely have a correlative impact on significantly more than 20 to 30 percent of vehicles in the pool. Thus, all of the vehicles in the pool will

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[11] Electronically attached to submission materials as: "016." Discussed at pgs. 7-9.

experience a purported “loss” event, but not because there was an actual inherent loss. Rather, the purported “loss” occurs because the vehicles’ depreciation rates are directly tied to the unemployment rate. As the unemployment rate increases, the depreciation rate increases, decreasing the residual value of the vehicles over the term of the contract. Accordingly, we think the better argument is that the Taxpayer cannot sufficiently utilize the law of large numbers to distribute its risk among the protected assets to achieve risk distribution in its commonly defined sense.

For all of the above reasons, we conclude that a contract labeled " value insurance" that “insures” against market decline is not a contract of insurance for federal income tax purposes. Consequently, for contracts, Taxpayer must use § 451 and § 461 of the Code to determine the taxable year for which items of gross income are included and the taxable year for which deductions are taken.

Taxpayer must include a payment received from a protected party in gross income when all the events have occurred that fix the right to receive income and the amount of the income can be determined with reasonable accuracy (the "all-events test") in accordance with § 451 of the Code and § 1.451-1(a) of the regulations. In particular, Taxpayer must include a payment received from a protected party into income no later than the year in which the payment is earned, due, or received (whichever happens first).

Taxpayer must treat its liability for residual value payments made to a protected party as incurred no earlier than in the taxable year in which all the events have occurred that establish the fact of the liability, the amount of the liability can be determined with reasonable accuracy, and economic performance has occurred with respect to the liability, in accordance with the principles of § 461 of the Code and § 1.461-1(a)(2)(i) and § 1.461-4(g)(7) of the regulations. In particular, Taxpayer may treat the liability for the residual value payments as incurred no earlier than the year in which Taxpayer pays the protected party.

CAVEATS:

A copy of this technical advice memorandum is to be given to the taxpayer. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.