Office of Chief Counsel
Internal Revenue Service
Memorandum

Number: **201511021**
Release Date: 3/13/2015

CC:FIP:B04:JEGlover
POSTF-129888-14

Third Party Communication: None
Date of Communication: Not Applicable

UILC: 831.00-00

date: December 01, 2014

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subject: Foreign Currency Swap

This Chief Counsel Advice responds to your request for assistance. This advice may not be used or cited as precedent.

LEGEND

Taxpayer =

Captive =

State =

Title =

Year 1 =

Year 2 =

Month A =

Month B =

Date A =

Date B =

Number A =

Number B =

Number C =

Number D =

Number E =

Number F =

Number G =

Number H =

Number I =

Number J =

Outside Actuary =

Actuarial Review =

ISSUE

Whether the arrangement between members of Taxpayer Group and the Group's affiliated insurance company involving foreign currency fluctuations constitutes insurance for Federal tax purposes?

CONCLUSION

The arrangement between members of Taxpayer Group and the Group's affiliated insurance company involving foreign currency fluctuations does not constitute insurance for Federal tax purposes.

FACTS

Taxpayer Group designs, manufactures, and markets professional, medical, industrial, and commercial products and services in the environmental and life sciences sectors. Taxpayer Group conducts this business through many subsidiaries (at least Number A U.S. subsidiaries); Taxpayer is the ultimate parent corporation (Parent).

Typical of such structures, Taxpayer Group includes a captive insurance company (Captive), which is regulated under State law. Captive provides coverage to the Taxpayer Group for automobile liability, products and general liability workers' compensation, product warranty, credit guarantee insurance, earthquake damage coverage, retiree medical cost coverage, and guaranteed renewable accident and health insurance.[1]

Because Taxpayer Group conducts business throughout the world, "sales and purchases in currencies other than the U.S. dollar expose [Taxpayer Group] to fluctuations in foreign currencies relative to the U.S. dollar and may adversely affect [Taxpayer Group's] results of operations and financial condition." Taxpayer Group has generally accepted the exposure to exchange rate movements without using derivative financial instruments. But by early Year 1, Taxpayer Group began to explore avenues for mitigating this risk, including the possibility of insuring earnings losses arising from foreign exchange fluctuations through Captive.

Beginning in Month A, Year 1, Parent entered into contracts with Captive on behalf of at least Number A members of the Taxpayer Group regarding the risk arising from fluctuations in the rate of exchange between the U.S. dollar and certain foreign currencies. There are two categories of contracts: Contract 1 protects the member against a decrease in the value of the specified foreign currencies, while Contract 2 protects the member against an increase in value of the specified foreign currencies. Both Contracts are entitled "Title."

Under Contract 1, Captive agreed to indemnify the participating members of the Taxpayer Group for the amount of "loss of earnings" connected to a decrease in the value of each specified foreign currency relative to the U.S. dollar up to a stated coverage limit for the period (1 year) stated in the contract. The coverage limit was the lesser of (i) an undefined "specified loss limit" (which LB&I believes is based on the prior year's export sales), or (ii) the sales revenue during the contract period. Contract 1 covered Number B different currencies.

Under Contract 2, Captive agreed to indemnify the participating members of the Taxpayer Group for the amount of "loss of earnings" connected to an increase in the value of each specified foreign currency relative to the U.S. dollar up to a stated coverage limit for each period (1 year) stated in the contract. The coverage limit was an

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[1] We offer no opinion whether these risks, and the structure of the arrangement between the members of Taxpayer Group and Captive constitutes insurance for Federal tax purposes.

undefined “specified loss limit” (which LB&I the Field believes is based on the amount owed on outstanding debt instruments). Contract 2 covered Number C different currencies.

For each Contract, “loss of earnings” is defined as the percentage increase or decrease in the rate of exchange of the U.S. dollar against the specified foreign currency between the effective and expiration dates multiplied by the coverage limit. In the tax opinion obtained on the contracts, the taxpayer represents that this loss of earnings does not measure the actual loss suffered by the change in exchange rate, but rather “provides a reasonable approximation” of the actual loss.

Endorsements extending the coverage of both Contract 1 and Contract 2 were issued monthly. That is, the initial contracts were issued for the period Date A, Year 1 through Date B, Year 2, but for each month subsequent an endorsement was added to provide coverage for the following year; for example, an endorsement would have been added in Month B, Year 1 to cover the period from Month B, Year 1 through Month B, Year 2. “By staggering the purchase of foreign currency exchange risk coverage over each of 12 months during each year, each [participant] obtains protection against the trend of a strengthening or weakening dollar (whichever side the coverage responds to).”

For each Contract, the premium was determined by multiplying the “rate of premium” by the coverage limit. Initially, the rate of premium per dollar of coverage is defined as twice the amount of premium as quoted by Bloomberg on the effective date, as a percentage of ‘notional’ for a 12-month call option contract for the purchase of U.S. dollars against the specified foreign currency. The premium listed in each Contract was a deposit premium only; the maximum that each participant would be required to pay. The actual premium was determined after the expiration date, based on the actual loss experience. The final premium was the lesser of the ‘retrospective adjusted premium’ and the deposit premium. The retrospective adjusted premium was defined as the deposit premium less the ‘retrospective premium adjustment’, which is (i) Number D% of the deposit premium minus (ii) paid losses in excess of Number E% of the deposit premium. If the retrospective adjusted premium is less than the deposit premium, Captive will refund the difference to the participant. If the retrospective adjusted premium is greater than the deposit premium, the participant does not pay additional premium; the deposit premium is the maximum premium. It was noted in the tax opinion that as the program gathers experience, the pricing of premiums charged will be based on experience. The premium reconciliation is computed at the expiration of each contract.

The contracts at issue have many features commonly found in insurance policies. In addition, the contracts exclude any loss which is covered under property insurance or business interruption insurance.

As many as Number F members of the Taxpayer Group participated in Contract 1, but only Number G members of the Taxpayer Group participated in Contract 2. It appears

that “most of the [participants’ purchase[d] coverage with respect to less than all of the [foreign currencies specified in the Contract].” It was anticipated that no one participant would account for more than 15 percent of the premiums paid to Captive with respect to Contracts 1 and 2. There is no mention of any parental guarantee, premium loan back, or other aspect of the arrangement that would be inconsistent with a bona fide insurance arrangement.

Outside Actuary performed Actuarial Review, noting that “the coverage limits are derived as a function of the prior year production for each [participant], separately.” With respect to the premium structure,

> The final premiums are a function of both the currency options market 1 year call premium and the actual loss experience as adjusted by the retro premium feature. The deposit premium rates are determined as twice the 1 year call option rate for each currency pair, separately.
>
> The retro premium adjustment is a risk sharing mechanism that recasts the final loss ratios most notably where actual losses are between [Number E]% and [Number H]% of the deposit premium amounts.

In describing the critical actuarial assumptions underlying the program, it is observed that the design aims to dampen the effect of any fluctuations.

> The offset effect is simple and derives from the two sets of inverse currency pairs…. By definition within the [program] structure if one pair is generating unfavorable loss experience, then its inverse pair is experiencing favorable underwriting results” though the offset “is only partial since the premium written amounts are not equivalent and the [program] retains [Number I]+ other currency pairs with no offsetting currency pair….
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> Even though [Number I]+ currency pairs are measured against the U.S. dollar it is highly unlikely that all of these would move directionally the same way, at the same time, and to the same extent. … Note that each endorsement attaches at a risk level determined initially by the exchange rate on the first day of insurance coverage. The coverage period is for one year. These endorsements are then layered in month after month so that at any point in time there are [Number J] active in-force policies in effect at varying stages of development maturity.

> Currency rate changes derive from an autoregressive statistical process. When viewed as a time series these curves tend to move in a sine wave type pattern centered about their long-term grand means. … If the risk exposure attaches at some low ebb on the wave then it is likely that the policy will settle at some higher point on the curve (a year later) thereby generating insured losses. Conversely, if the risk exposure attaches at a high peak on the wave it is likely that the policy will settle at some lower point on the curve thereby generating a zero loss outcome. Because the policy endorsements are attaching (and expiring) monthly this risk layering feature yields a cumulative net loss ratio profile which quickly converges to a relatively narrow band around the central program wide mean ratio.

LAW AND ANALYSIS

Law

In general, neither the Internal Revenue Code nor the Income Tax Regulations define the terms "insurance" or "insurance contract" for Federal Income Tax purposes.[2] 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, 861-864 (7th Cir. 1992). The most frequently cited opinion on the definition of insurance is Helvering v. Le Gierse, 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 having the following three elements: (1) 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

[2] Regulations under the Foreign Account Tax Compliance Act (FATCA) define insurance company and insurance contract. See § 1.1471-1(b) (60) and (61). Section 1.1471-1 provides definitions for terms used in chapter 4 of the Code.

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[3] 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.

The predicate of insurance is "insurance risk." The risk must be the risk of an economic loss. Allied Fidelity Corp. v. Commissioner, 572 F.2d 1190, 1193 (7th Cir. 1978). The failure to achieve a desired investment return is an investment risk, not an economic loss giving rise to an insurance risk. In the seminal Le Gierse case, the Court stated that the risk involved in the combination life insurance-annuity contract arrangement was whether the prepayment would earn less than the amount paid as a benefit. This, the Court concluded "was an investment risk similar to the risk assumed by a bank; it was not an insurance risk". Le Gierse, 312 U.S. at 542. See also Sec. and Exch. Comm'n v. United Benefit Life Ins. Co., 387 U.S. 202, 211 (1967) (citing Le Gierse for the proposition that "[a]nd while the guarantee of cash value based on net premiums reduces substantially the investment of risk of the contract holder, the assumption of an investment risk cannot by itself create an insurance provision under the federal definition.").

Rev. Rul. 2002-90, 2002-2 C.B. 985, holds than an arrangement between a licensed insurance subsidiary of parent, and each of the 12 of parent's operating subsidiaries where, *inter alia*, no one subsidiary accounts for less than 5 percent nor more than 15 percent of the total risk insured by the insurance subsidiary constitutes insurance. In the ruling the insurance subsidiary is adequately capitalized, it charges arm's length premiums established according to customary industry rating formulas, there are no parental guarantee or premium loan backs, and the parties conduct themselves in a manner consistent with the standards applicable to an insurance arrangement between unrelated parties.

Statement of Statutory Accounting No. 60, Financial Guaranty Insurance, describes such insurance as providing "protection against financial loss as a result of … fluctuations in exchange rates between currencies".

"For plain vanilla FX options, pricing generally conforms quite closely to appropriately adjusted Black-Scholes model values, and models of this type are used throughout the

[3] In considering whether a variable annuity contract was subject to the securities laws, the Court noted that "[i]t is apparent that there is no uniformity in the rulings of the States on the nature of these 'annuity' contracts. In any event how the States may have ruled is not decisive. For, as we have said, the meaning of 'insurance' and 'annuity' under these Federal Acts is a federal question." Sec.and Exch. Comm'n v. Variable Annuity Life Ins. Co., 359 U.S. 65, 69 (1959).

market to price FX options." Kolb, Robert W. and Overdahl, James A., Financial Derivatives Pricing and Risk Management 119 (John Wiley & Sons 2010).[4]

Investopedia defines a currency swap to be "an agreement to make a currency exchange between two foreign parties. The agreement consists of swapping principal and interest payments on a loan made in one currency for principal and interest payments of a loan of equal value in another currency."

Section 988 provides rules for the tax treatment of certain foreign currency transactions. Under § 1.988-1(a)(2)(iii), included among the transactions subject to § 988 are the "entering into or acquiring of any forward contract, futures contract, option, warrant, or similar financial instrument … if the underlying property to which the instrument relates is a nonfunctional currency or is otherwise described in" § 1.988-1(a)(1)(ii). Section 1.446-3(c)(1) defines a notional principle contract as "a financial instrument that provides for the payment of amounts by one party to another at specified intervals calculated by reference to a specified index upon a notional principal amount in exchange for specified consideration or a promise to pay similar amounts", which includes currency swaps. The definition provides that "to the extent that the rules provided in this section are inconsistent with the rules that apply to any notional principal contract that is also a section 988 transaction, … the rules of section 988 and the regulations thereunder govern."

In Rev. Rul. 2005-40, 2005-2 C.B. 40, situation 1, X owns and operates a large fleet of automotive vehicles representing a significant volume of independent, homogeneous risks. X paid premiums to Y in return for Y "insuring" X against the risk of loss arising out of the operation of its fleet in the conduct of its courier business. In situation 2, the facts are the same but Y "insures" a second corporation. Consequently, X had 90% of Y's total risk exposure and the second corporation 10% of the total. Rev. Rul. 2005-40 indicated that courts have recognized that risk distribution necessarily entails a pooling of premiums, so that a potential insured is not in significant part paying for its own risks (cites not included). The Rev. Rul. states that: "Although the arrangement may shift the risks of X to Y, those risks are not, in turn, distributed among other insureds or policyholders." Rev. Rul. 2005-40 concluded that both situation 1 and 2 did not constitute insurance.

Analysis

We have examined the substance of the arrangements labeled " Title" (both Contract 1 and Contract 2) and conclude that the contracts do not satisfy the three-factor test defining insurance set forth in case law. The arrangements are not insurance because they lack insurance risk, and they are not insurance in its commonly accepted sense. Contract 2 is also not insurance because it lacks risk distribution.

[4] FX is the acronym for foreign currency.

Insurance Risk

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).

Insurance risk requires a fortuitous event or hazard and not a mere timing or investment risk. A fortuitous event[5] (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).

When evaluating whether an arrangement constitutes insurance for Federal tax purposes, the first inquiry is whether the subject risk is properly viewed as an “insurance risk” or as a risk of another nature, such as investment, or perhaps synonymously, ‘business’ risk.

What is an investment (or business) risk? You buy stock with the intent to make a profit. That risk of success is an investment risk. A business owner invests its capital in a business enterprise with the intent to make a profit. A business has an unlimited number of economic risks. The factory building may burn down. The business may not make a profit because it fails to obtain sufficient raw materials, gross receipts, or customers. Are all of these economic risks insurance risks? Is a business risk an investment risk of a business?

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[5] 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."

In deciding whether a contract does not qualify as an insurance contract for federal tax purposes because it involves an investment or business risk, we submit that all of the facts and circumstances associated with the parties in the context of the arrangement should be considered. One should take into account such things as the ordinary activities of a business enterprise, the typical activities and obligations of running a business, whether an action that might be covered by a policy is in the control of the insured within a business context, whether the economic risk involved is a market risk that is part of the business environment, whether the insured is required by a law or regulation to pay for the covered claim, and whether the action in question is willful or inevitable.

The risk involved in this arrangement is an investment-type risk as it is solely the manifestation of fiat currency valuation.[6] Although SSAP No. 60 references protection against the fluctuation in currency exchange rates, “insurance” for this risk does not appear to be commonly available from the major carriers. Rather, it appears that the risk of loss from fluctuations in currency exchange rates are typically mitigated by derivative contracts; this arrangement bears resemblance to a notional principal contract or other type of a § 988 transaction. This is borne out given that the premium paid by the participants is determined with reference to commercially available options and the fact that the arrangement is ‘layered’ through endorsements that expire monthly, producing periodic monthly settlements based on the trailing 12 months’ results. Finally, while retrospective rating is common, it is not clear that the formula employed here (which results in a refund of Number D% of premium if losses are less than Number E% of the initial deposit) is consistent with common retrospective rating methodologies.

Under Contract 1 and Contract 2, Captive agreed to indemnify the participating members of the Taxpayer Group for the amount of “loss of earnings”. For each Contract, “loss of earnings” is defined as the percentage increase or decrease in the rate of exchange of the U.S. dollar against the specified foreign currency between the effective and expiration dates multiplied by the coverage limit. In the tax opinion obtained on the contracts, the taxpayer represents that this loss of earnings does not measure the actual loss suffered by the change in exchange rate, but rather “provides a reasonable approximation” of the actual loss.

In this case, participants in the contracts are primarily interested in selling their goods and services at a profit, that is, with a positive return on their capital investment. The participants have an economic risk that they will not make a profit on the sale of those goods and services (without regard to foreign currency exchange rates). This risk is an economic risk which is an investment (or business) risk. The existence of foreign currency exchange rate protection does not change the investment risk of making a profit on the sale of goods or services. It only reduces or eliminates that risk. Thus, a seller of goods or services (i.e. the protection buyer) can purchase options on the open

[6] Presently, no country uses ‘the gold standard’ to value its currency.

market to protect against currency fluctuations or enter into a contract arrangement similar to the contracts at issue. The economic effect is the same. This investment risk is not an insurance risk and therefore the contracts are not insurance.

Commonly Accepted Sense

The contracts are not insurance in its commonly accepted sense. The fact that other companies that offer traditional insurance agreements 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 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. 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. 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 losses covered under property insurance or business interruption insurance.

The contracts will indemnify for the amount of loss of earnings sustained due to an increase (or decrease) in the value of specified foreign currency relative to the U.S. dollar. Various market forces can affect foreign currency exchange rates, but the occurrence of these events is not the casualty event. The event that triggers Taxpayer’s liability is the termination of the contract. During the contract term, currency exchange rates may, and probably will, change. But during the contract term, no loss is incurred on the sale of goods and services. Only at the end of the contract term is there a determination as to whether sufficient profit has been made. We conclude that contract termination is not the type of event that gives rise to a casualty event. Nor do we believe that any change in a foreign currency exchange rate is a casualty event in the commonly accepted sense. The contract is not insurance in its commonly accepted sense.

Risk Distribution

The captive insurance company sold Number G of Contract 2. Under the reasoning of Rev. Rul. 2005-40, the contract lacks risk distribution and thus is not insurance for tax purposes.

Tax Accounting

Additionally, [redacted] the timing of the income and deductions are determined under the all events tests of §§ 451 and 461 and that the liability is an "other" payment liability under § 1.461-4(g)(7) and cannot be considered incurred until paid. [redacted] the liability does not become fixed until the end of the coverage period, but the recurring item exception is not available for § 1.461-4(g)(7) liabilities.

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