TAXATION SECTION
"A KNOWLEDGE COMMUNITY FOR THE SOCIETY OF ACTUARIES"
SEPTEMBER 2008
SUPPLEMENT
TAXING TIMES

Note to Our Readers

You will notice that this September issue of *Taxing Times* is arriving to you in two pieces—the full issue and this supplement. Given the significance of the topic discussed in the article below and the volume of the September issue, the decision was made to separately publish this supplement.

I hope you enjoy both the full issue and the supplement.

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Fortuity, Or Not Fortuity? ... That Is The Question

by Frederic J. Gelfond

By now, most insurance tax practitioners are likely familiar with the oft cited refrain that in order for an arrangement to qualify as insurance for federal income tax purposes, it must involve the presence of an insurance risk, risk shifting, and risk distribution, and it must satisfy common notions of insurance. Nevertheless, questions continue to arise as to what these concepts mean and how they should be applied. Getting answers to these questions has become even more important over the years given the nature of insurance as an industry that is built on innovation and the seemingly never-ending quest to find ways to efficiently manage risk. Moreover, the evolution among financial products, in general, continues, with the development of capital market vehicles that may be intended to, or appear to, mimic insurance products in terms of effectively hedging risk, but that do not rely on principles of insurance in design, actual operation, or under the law.

To their credit, the Treasury Department (Treasury) and Internal Revenue Service (IRS or Service), have over the last year or so, issued several pronouncements that provide guidance as to the government's position relative to the issues involved. In particular, they have issued guidance dealing with concepts of fortuity, homogeneity, and risk distribution, among others.

As one might expect, these releases have, in turn, resulted in a great deal of discussion within the insurance tax community as to how the definition of insurance that is being utilized by the Treasury and the IRS for federal income tax purposes comports with how that term is understood within the insurance industry from the actuarial, legal, academic, and other perspectives. The key concern of course is whether a product developed, or an arrangement set up based on insurance principles, and hence otherwise understood to be insurance, will be respected as such for federal income tax purposes as well.

To illustrate some of these insurance principles, immediately following this introduction is a brief narrative that describes a risk scenario and suggests a possible means for managing that risk through an arrangement that arguably qualifies as insurance. Because the scenario involves some element of advance knowledge regarding claims under the arrangement, the pages that follow will discuss the government's analysis in Rev. Rul. 89-96, commonly referred to as the MGM Grand ruling, which dealt with a layer of liability insurance coverage for a catastrophe that had already occurred.

The analysis in that ruling is then compared to a new approach introduced by the government nearly 20 years

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TAXING TIMES
Supplement
September 2008

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later in Rev. Rul. 2007-47, which involved a fact pattern similar to that set forth in the below narrative. The article next raises a question as to whether the new approach taken by the government in Rev. Rul. 2007-47 is too restrictive, and then walks through a series of authorities—tax and non-tax—that describe the fundamental characteristics that one should look for in determining whether an arrangement qualifies as insurance.

Risky Business

Imagine that you own a business that is in a heavily regulated industry and that has plant operations that cause pollution and other residual harm to the environment. You knew when you first entered that business about 30 years ago, that when the plant permanently ceased operations, you would have to meet the regulatory standards established by several federal and state authorities relating to the removal, storage and disposal of harmful material and the decontamination of the property. At the time, it was widely understood that the costs involved in undertaking such remediation procedures would not exceed the salvage value of the plant.

Over time, the requirements as to what had to be done to clean up a plant site in the United States increased dramatically—laws changed, new environmental standards were imposed, etc.—and as one would expect, the expected costs of performing these tasks went up as well. Nevertheless, the required annual estimates of the costs of clean up for a given plant continue to fluctuate widely from year to year. In fact, it is common for the cost estimates for a particular plant to go either up or down by hundreds of millions of dollars from one year to the next.

And those estimates cover only the expected costs of cleaning up the pollution that you know the plant caused, or will cause during its operation. That is, you always knew that a certain level of pollution would occur as a result of the operation of the plant. Until beginning the remediation processes, however, it is not possible to know the extent of the pollution that occurred and the procedures that will need to be undertaken to decontaminate the property it sits on, and potentially, other property as well. There could have been levels of pollution that could not have been reasonably expected. It is possible that you might discover unexpected contamination that must also be removed; such as incidental contamination that might have occurred to groundwater or soil in areas not accessible during plant operation (leaky pipe, perhaps?), not to mention your neighbor's lake.

In addition, other events might occur that could also significantly affect the costs. This includes the constant changing of the required regulatory procedures and the standards that must be observed. Obligations of plant owners may not have existed or otherwise been knowable at the time the plant began operations or before the remediation processes began.

If the federal government decides not to build a storage facility as they said they would, who knows what it is going to cost to safely store the harmful waste? Also, do not forget the tariffs that several states are beginning to impose for merely transporting such waste across state lines.

Of course, an accident forcing a closure can happen as well; the severity of which could also cause hard to imagine additional clean-up costs. Further, if several plants happen to close down at the same time, the scarcity of the specialized equipment and labor needed to conduct the remediation processes will drive the costs up; both due to supply and demand factors, as well as the costs resulting from shortages of labor and equipment that interrupt the scheduling of the sequential processes involved.

Should a plant be forced to close down prematurely due to such things as an accident, terrorist attack, equipment failure, or even state action, that too will drive the costs up. Not only will the funds necessary to perform the clean-up be needed sooner, but industry estimates indicate that the additional processes that are necessary in a premature closure scenario could cause the costs to increase by nine figures. So, while timing is not everything, it is a major factor affecting the amount of cleanup costs.

On the other hand, advances in technology and experience gained from earlier plant closures, among other things, could help to drive costs down.

History has also shown that the costs of cleaning the pollution relating to a plant closure can end up being significantly less than what was initially estimated. In fact, a survey of a group of similar plants undergoing these types of procedures show that the respective positive and negative variances from estimated costs from one plant to another virtually cancel each other out when those plants are looked at in the aggregate. That is, each plant, standing on its own, had a significant variance from the associated estimates. Some of them incurred costs that were significantly greater than the estimates, and others incurred costs that were significantly less than the estimates. The aggregate actual costs for the industry group, however, were less than, albeit close to, the aggregate estimated costs for the group.

To summarize, it appears that with respect to any plant, there is going to be an expected amount of clean-up costs incurred. The most advanced techniques are utilized to estimate what those costs will be; and those estimates are performed annually. Nevertheless, there are a number of contingencies that can occur that will significantly affect the ultimate costs of performing the clean-up. Such contingencies can result in either a positive or negative impact on the costs incurred.

Plant owners can plan for the expected, and set aside funds that will grow to the amount needed to cover a range of estimated future costs; one that considers the impact of the occurrence of negative contingent developments. They can take all the appropriate measures to ensure that negative consequences do not occur, but several things are out of their control. They cannot plan for the impact of the occurrence of all of the reasonably foreseeable, but nevertheless unexpected, negative contingencies; *e.g.*, terrorist attack, state action, or new regulatory standards. As a result, given the number of potentially negative contingencies, the volatility of the associated costs, and an industry history that illustrates frequent significant variances between actual and expected experience, it is inevitable that any given plant might find itself in a position where it has not set aside sufficient funds to satisfy its remediation requirements.

Given the benefit of hindsight as to the aggregate experience of the industry to date, but not as to the experience of any individual plant, perhaps the members of the above-described industry group would have determined ahead of time that it would make logical business sense to pool the funds they had each individually set aside. In exchange for doing so, they could have mutually agreed that the aggregate funds in the pool, and the investment earnings thereon, would be used to cover each party's costs of performing remediation procedures, including amounts incurred by certain of the plants that unexpectedly exceeded cost estimates, including those that were prematurely closed. Some of the plants would end up transferring to the pool amounts that were in excess of the present value of their ultimate costs. Others would transfer less than the benefit they received. They all would have received certainty, however, that their costs would be covered even if such costs were greater than what they expected due to the occurrence of negative contingencies.

Certainly, an undertaking of that nature would require a good degree of diligence in order to determine precisely how much of the unexpected costs per plant the pool could withstand, or otherwise, how much each plant owner should be required to contribute to the pool to ensure the continued solvency of the pool. A study of prior industry experience, multiple simulations of possible alternative outcomes for the group as a whole, a quantification of the efficiencies that can be gained from the pooling aspects of the arrangement, and the establishment of standards as to who could enter the pool would all inform those decisions.

Assuming there is sufficient prior industry experience upon which to base such analyses, each plant owner would obtain the ability to cover at least some unexpected layer of costs it potentially could be faced with as the result of the occurrence of negative contingencies; an amount in excess of what it practically would have set aside on its own, with such necessary excess funds being available when needed. Moreover, they would be able to satisfy those potential

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additional costs for the same amount of funds that would have otherwise been sufficient to cover only their expected costs.

In other words, each of the plant owners would have acquired insurance! Or would they?

That is, they would have each acquired through the use of a pooling mechanism, protection against potential negative variance from expected costs associated with pure risks against which they were all independently exposed. Is this insurance?

It is virtually certain that a claim will be made by each of the participants in the pool at some point in time, and payments under the arrangement will include nominally large payouts of amounts to cover expected costs. To wit, all the parties know that a portion of the contamination for which claims will be made has already occurred. Nevertheless, it is the assumption by the pool of the risk of potential variation from expected, the utilization of pooling to manage the relationship between the aggregate actual and expected costs, and the nature of the underlying risk that establish the insurance characterization of the arrangement.

The IRS/Treasury View . . . Then and Now

Rev. Rul. 2007-47 states that an arrangement similar to that described above was not insurance based on a finding that the transaction lacked fortuity. The ruling states that it amplifies Rev. Rul. 89-96. The two rulings, however, involve fundamentally different sets of facts, with the latter ruling utilizing a new approach to characterize a transaction that would likely be found to constitute insurance under the mode of analysis utilized in Rev. Rul. 89-96.

That Was Then . . .

In Rev. Rul. 89-96, the IRS analyzed whether the risk that was the subject of an insurance contract constituted an insurance risk for federal income tax purposes. In doing so, the Service did not examine the qualitative nature of the coverage described in the insurance contract. Rather, the Service looked to the economic terms of the contract, and, based on those terms, it found that the only risk that was transferred to the insurance company was an investment risk. The Service recognized a distinction between investment risk and insurance risk, and concluded that the assumption of an investment risk, by itself, cannot serve as the sole basis of an insurance contract for federal income tax purposes.

In effect, the Service adopted an approach that inherently focuses on the notion that there is, or can be, a difference between the covered risk that is the subject matter of an insurance contract—in this case, claims resulting from a catastrophe—and the type of risk assumed by the insurance company. That is, it did not suggest that the covered risk under the arrangement was not the appropriate subject matter of an insurance contract. Rather, it effectively stated that the insurance company did not economically assume the covered risk. The Service did not use this terminology, but what is nevertheless inherent in its ruling that the only thing transferred was an investment risk, is that the insurance company did not take on an underwriting risk.

Although the meaning of the term has been expressed in several different ways, underwriting risk essentially relates to the variance that can occur between actual and expected results relative to the covered risks taken on by an insurance company. For example, it could occur as the result of such things as uncertainty regarding the true value of expected losses or insufficient diversification or over-correlation of risks.

Fundamental to the conclusion in Rev. Rul. 89-96 is the fact that the amount that the insurance company would ultimately have been liable to pay under the subject contract was known in advance by both parties to the arrangement. The arrangement involved a layer of insurance coverage on a catastrophe that occurred before the contract was entered into. At the time the contract was entered into, the policyholder had already incurred liabilities related to the catastrophe that were expected to substantially exceed the policy limit. As set forth in the ruling, the insurance company established a reserve equal to the maximum amount that could be paid under the policy on the basis of facts known at the time the contract was entered into.

The Service effectively found that by virtue of the fact that the parties knew the amount that would ultimately be paid under the contract, they could simply set a premium based substantially on the present value of that amount. More precisely, the IRS applied a formula that took the total of the premiums paid under the contract plus the tax savings to the insurance company on its related loss reserve deduction plus the investment earnings on the premiums paid, and found that the

sum of those amounts to be received by the insurance company would probably exceed the policy limit; *i.e.*, the maximum amount it would have to pay out under the contract. In this case, the only contingency under the formula was the amount of investment earnings on the premiums paid. As such, the Service determined that the contract transferred only an investment risk.

The consideration of the tax position of the insurance company in analyzing whether an insurance risk was transferred was unprecedented. Although that aspect of the ruling continues to be the subject of considerable discussion, the focus here is on the IRS's conclusion that the only risk truly assumed by the insurance company was that the investment earnings on the premiums paid would not grow a sufficient amount by the time the insurance company would be required to make payments under the contract. Based on that conclusion, the ruling held that the transaction did not qualify as insurance for federal income tax purposes.

Of course, insurance companies never take on "covered risks!" At least they do not take on individual covered risks in isolation of each other. Rather, insurance companies combine, or pool multiple independent covered risks. Through reliance on Bernoulli's theorem, or the law of large numbers, they are able to predict an expected amount of loss among a pool of covered risks as a whole.

That is, as the number of independent, randomly occurring risks increases, the law of large numbers operates such that the ratio of actual to expected losses tends to approach one for the group.[1] Through the application of the insurance principle of pooling, the insurance company can become more comfortable that the total actual amount of claims paid will correlate with the expected cost of those claims and, in turn, correlate with the total amount of premiums collected.

Moreover, because the statistical analysis performed by the insurer will enable it to determine the average expected cost per unit of risk for the group, it can then establish a premium amount per unit of risk that is less than the maximum possible loss per unit. As such, as a result of the operation of insurance principles, the cost of covering such units of risk by participating in a pooling arrangement would be less than the maximum loss per unit of risk that is not pooled.

Under a set of facts such as those articulated in Rev. Rul. 89-96, where the amount of the claim was known in advance, the ratio of actual to expected losses was equal to one without having to rely on insurance principles. That is, the actual was equal to the expected from the outset. This would not have changed with respect to that insured risk regardless of whether it was part of a pool. A ratio of one was achieved, but not by virtue of pooling; *i.e.,* absent the operation of insurance principles. Reasonable parties would not price such risk based on any impact of pooling. Rather, they would more simply seek to determine an appropriate discount rate. In such case, the only risk present is an investment risk.

Through the application of the insurance principle of pooling, the insurance company can become more comfortable that the total actual amount of claims paid will correlate with the expected cost of those claims. ...

... This is Now

Almost 20 years later, in July 2007, the Service issued another ruling—Rev. Rul. 2007-47—dealing with an insurance arrangement in which aspects of the coverage involved a known element. In that case, the known element related to the fact that it was virtually certain that claims would be made at some point, but it did not involve knowledge of either the amount or precise type of losses for which claims would be made, or the timing of when the claims would be made.

As a result, the fact pattern appears to have involved the insurance company taking on underwriting risk; *i.e.*, something more than an investment risk. Assuming that is the case, under the standard set forth in Rev. Rul. 89-96, the described transaction would appear to have qualified as insurance. The Service said, however, that the transaction did not so qualify. Although it analogized this case to Rev. Rul. 89-96, it applied a fundamentally different test in order to reach a similar conclusion.

While the ruling states that it amplifies Rev. Rul. 89-96, it does not attempt to reconcile how it achieved a similar result in both cases given the fundamental factual difference of a known amount of loss, and hence, the absence of the operation of insurance principles in one case, versus the uncertainty regarding loss, and the apparent operation of insurance principles in the other. The ruling also does not address its change in approach described below, in performing its analysis from the per

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spective of the insurance company in Rev. Rul. 89-96, and from that of the insured in Rev. Rul. 2007-47.

Parts Unknown

Similar to the risk scenario set forth in the above narrative, Rev. Rul. 2007-47 describes an insurance transaction in which the coverage involved the remediation of property that was undergoing harm as the result of the operation of an ongoing business process. It was anticipated that government regulation would require some degree of remediation at whatever time the policyholder ceased engaging in the business process. The precise amount and timing of the future costs to be incurred in this connection were subject to many contingencies.

Similar to Rev. Rul. 89-96, Rev. Rul. 2007-47 involved a scenario where it was highly likely, if not certain, that a claim would be made under the subject insurance contract. A key difference, however, was the fact that both the timing and the amount that would ultimately be payable under the contract were subject to contingent future events and, therefore, not knowable at the time the contract was entered into.[2]

The premium the policyholder paid for the contract was the present value of its estimate of its projected future costs of performing remediation procedures. Unlike the policy limit described in Rev. Rul. 89-96, the facts set forth in Rev. Rul. 2007-47 do not suggest that the policy limit is a mere reflection of the policyholder's estimate of future costs that were discounted back to determine the premium. In other words, it contemplates a scenario where the policy limit is greater than the estimated future costs; *i.e.,* as might occur in a situation where a policyholder is seeking protection against adverse experience relating to costs or losses greater than what is expected at the time a contract is entered into. Contrast this with the precise fact that served as the basis of the conclusion in Rev. Rul. 89-96, that it was known in advance that the total losses, or claims, would be in excess of the policy limit.

It was anticipated that government regulation would require some degree of remediation at whatever time the policyholder ceased engaging in the business process.

Because the timing and amount of the claims ultimately payable under the contract were not known or knowable, one could not simply perform a present value analysis of the projected future costs to set the premium without expecting that the arrangement would result in the transfer of some element of risk beyond a pure investment risk. As explicitly stated in the analysis in the ruling, the insurance company assumed the risks of the scope of the required remediation measures, projections of future costs involved in the remediation processes, the time frame when the costs would be incurred, and the determination of a discount rate.[3] Thus, the insurance company assumed the liability for the unexpected costs up to the policy limit.[4]

The analysis section of the ruling nevertheless states that the arrangement was merely a pre-funding of the policyholder's future obligations, and that the overall risk assumed by the insurance company was whether the estimated present value of the cost of performing the remediation procedures, which was the premium amount paid by the policyholder, would accrue to the greater of the amount of claims under the insurance contract or the policy limit. It then states that this risk is akin to the timing and investment risks that Rev. Rul. 89-96 concludes are not insurance risks.

The facts in the ruling, however, do not contain the additional necessary fact to reach such conclusion. That fact would have been that the policy limit was set at an amount equal to or less than the estimated costs. Thus, it appears that the rationale underlying the ruling is intended to apply even in a situation where the maximum amount that the insurance company could potentially be required to pay would be something in excess of the estimated costs.[5]

A rational insurance company, however, would not have taken on a risk beyond the estimated costs without being compensated for doing so. That is, it would not have simply accepted as a premium the present value of the estimated future costs for a coverage amount in excess of such future costs.

It would have done so, however, if it received some form of risk premium; in other words, a payment for taking on a degree of risk beyond the amount of estimated loss. And even in that case, it would have still needed to be able to undertake a pooling of risks in order to determine the amount of risk premium.

Given that the ruling indicates that the only premium paid was the present value of the estimated future costs, in

order for the ruling to be reflective of a realistic scenario, the risk premium in this case must be assumed to be contained within that amount. Because it is assumed that the revenue ruling is applicable in a case where the policy limit is greater than the estimated future costs for the payment of the present value of the estimated future costs, the policyholder is receiving coverage for an amount that is greater than those estimated future costs. In other words, it is reducing its cost of the risk units it transferred to the insurance company; and, in effect, purchasing protection against a negative variance in loss experience.

It is, therefore, inherent in the ruling that there are other risks being taken on by the insurance company under other insurance contracts, in addition to those described as being transferred by the referenced policyholder. Even if there were no other contracts involved, the necessary reference in the analysis section of the ruling to the "overall risk" assumed by the insurance company suggests that, if this were, in fact, its only contract, there is some element of pooling of several independent units of risk transferred by the subject contract alone.[6]

A Different Perspective and a New Approach

Despite the analogy to Rev. Rul. 89-96, the logic, or mechanical test, that was applied in establishing that, from the insurance company's perspective, the transaction in Rev. Rul. 89-96 involved only an investment risk, and not an insurance risk, could not be relied on to support a similar conclusion in a case where the ultimate amount and timing of claims is not known in advance. That is, because of the contingent nature of the future costs, there was no single variable that could be discounted back to reach a present value premium amount.

As stated above, the Service performed its analysis in Rev. Rul. 89-96 from the perspective of the insurance company. That is, it looked to see if it was taking on any risk other than an investment risk. While Rev. Rul. 2007-47 indicates that there is an investment risk that is inherent in the coverage it is providing, every insurance arrangement involves an element of risk that the funds it collects will not grow a sufficient amount at the time it is required to make payments. The ruling specifically states, however, that it is also assuming a number of other risks that are not investment related, such as those enumerated above. Although the ruling discusses the "overall risk" the insurance company is taking on, the insurance company is inarguably taking on risks that go beyond a pure investment risk. That fact, in and of itself, suggests that this type of arrangement cannot be disqualified as insurance under the rationale set forth in Rev. Rul. 89-96.

The Service appears to acknowledge this through its use of a different approach than was applied in Rev. Rul. 89-96. In Rev. Rul. 89-96, the Service looked solely to the economic terms of the contract; and did so from the perspective of the insurer. In Rev. Rul. 2007-47, the Service stated that in order to determine the nature of an arrangement for federal income tax purposes, it is necessary to look beyond the terms of the arrangement.

That is, because of the contingent nature of the future costs, there was no single variable that could be discounted back to reach a present value premium amount.

In doing so in Rev. Rul. 2007-47, the Service equated the term "insurance risk" to the concept of "fortuity." In applying the test in Rev. Rul. 2007-47, it looked solely to whether the policyholder would incur future costs, and hence, whether the insurance company would necessarily have to make at least some claim payments under the insurance contract.

Under the facts set forth in the ruling, is the requirement that the policyholder would incur at least some remediation costs attached at the time it began its business process. It was not known what the scope of the damages would be that the policyholder would be responsible for, what regulations might be in place that the policyholder would be required to comply with, or how soon the future costs would be incurred. It was, however, certain that the insurance company would be required to perform to at least some degree on the contract. Because it apparently viewed the entering into of the business process with knowledge that it would result in an estimable amount of damage as being the only insurable event for which there needed to be fortuity, the ruling held that the arrangement lacked the requisite insurance risk in order for the arrangement to constitute insurance for federal income tax purposes.

As such, the ruling limits the definition of fortuity to the question of "if" a loss would occur under a contract. In effect, it ignores the fact that there could also be fortuity as to events that would have an impact on either the size or timing of a claim. It thus appears to suggest that

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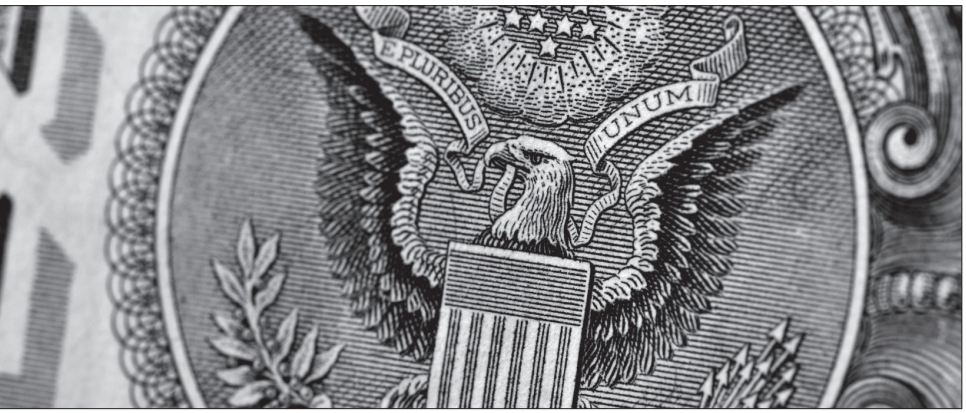

fortuity as to magnitude risk, is not, by itself, a sufficient basis for an insurance contract for federal income tax purposes.

Moreover, as in Rev. Rul. 89-96, the ruling does not state that the covered risks are not properly the subject of an insurance contract. It merely expresses concern that it is known that claims will be made with respect to some of them. In addition, it is recognized that these risks have been shifted to the insurance company, and it appears that the insurance principle of risk distribution is operating.

The ruling also does not explain how its analysis comports with what the courts, the IRS, and Treasury, have previously said regarding an expectation that claims would be made under an insurance contract, and the validity of insurance that covers uncertainty regarding coverage of only the amount or timing of loss.

It is understandable that Treasury and the Service would be concerned about taxpayers seeking to apply insurance tax rules with respect to arrangements effecting the prefunding of known obligations in transactions that do not involve a transfer of insurance risk. The arguably limited definition it appears to give the term fortuity in this context, however, could potentially result in the disallowance for federal income tax purposes of many otherwise accepted insurance transactions. Moreover, it suggests that the fundamental principles of insurance cannot operate in a situation where there is certainty regarding the existence, but not the amount or timing, of loss even when those items are subject to contingencies outside the control of any party.

Regardless of what perspective is taken in analyzing an insurance arrangement, Rev. Rul. 89-96 and Rev. Rul. 2007-47, taken together, highlight the IRS position regarding the need for some element of fortuity to exist in order to have an insurance arrangement. The question that remains is whether the manner in which Rev. Rul. 2007-47 appears to have defined the term fortuity will result in the disallowance of insurance tax treatment for arrangements involving the use of insurance tax principles to provide coverage against some forms of loss; in particular, situations involving severity of loss or magnitude risk. Taken to its logical extreme, the rationale utilized by the IRS and Treasury in this ruling arguably calls into question the insurance nature of excess loss coverage, certain environmental risk products, existing condition health coverage, and other common arrangements. Moreover, the rationale in the ruling that certainty of a claim negates the insurance nature of a product calls into question a small segment of the insurance market referred to as "life insurance."

In summary, the clear difference between the two rulings is that in Rev. Rul. 2007-47, the economics of the arrangement for both parties was necessarily dependent on the operation of insurance principles; the covered risk, in addition to any investment risk, could only be mitigated through the use of pooling.[7] In Rev. Rul. 89-96, the parties knew in advance what the precise amount of claims would be when the transaction was entered into. As a result, the terms of the arrangement were not based on the operation of insurance principles.

In nevertheless finding that the transaction in Rev. Rul. 2007-47 did not constitute insurance, Treasury and IRS reasoned that the transaction did not involve fortuity. As an initial matter, if fortuity is the hallmark of an insurance arrangement, then it is not clear why the transaction in Rev. Rul. 89-96 was not disallowed as such on that basis alone; that is, without even having to go through the additional analysis as to whether it involved something more than an investment risk.

This is not to suggest that fortuity is not a key element of most insurance arrangements. Perhaps the real question, however, is what aspect of an arrangement needs to be fortuitous in order for the arrangement to be treated as insurance. That is, does there need to be fortuity as to whether there has been an occurrence that will result in a claim? Or does the concept more broadly consider the ultimate impact, or outcome of an occurrence? See, for example, the Dictionary of Insurance that suggests through its definition of risk that insurance contemplates "Uncertainty as to the outcome of an event.[8] …"[9]

Further, is it sufficient if there is fortuity solely as to the timing of an occurrence—as is the case under a whole life insurance contract, or with respect to coverage involving a premature cessation of operations under Rev. Rul. 2007-47—or even as to when the impact of such occurrence will be felt?

The insurance principle of pooling is fully capable of operating to bring the ratio of expected to actual near to one when there is fortuity solely with respect to uncertainty as to outcome or severity, or timing.

Although the term was not utilized in Rev. Rul. 89-96, it appears that there was no fortuity in that case as to any of these elements. In Rev. Rul. 2007-47 there was, at most, a lack of fortuity only as to the occurrence of activity that would result in a claim; but there was clearly uncertainty as to the ultimate amount of the payments under a claim as well as the timing of claims. In this way, the position set forth in Rev. Rul. 2007-47 disregards the fact that principles of insurance can operate with respect to the risks present under the posited facts. As a result, it goes beyond simply amplifying what is set forth in Rev. Rul. 89-96. It presents an alternative view to those authorities discussed below that recognize that insurance can exist if there is fortuity as to either an occurrence or happening, or an outcome or final result of such occurrence or happening.

A Closer Look at Fortuitous Elements of Insurance

The Risk Dimension

Numerous insurance authorities recognize that insurance provides protection against variability of loss. Many of these authorities have, in turn, been recognized by many tax authorities, including the IRS, that have sought to define insurance. For example, in *Ocean Drilling*,[10] the Federal Circuit, relied heavily on the testimony of Dr. Neil A. Doherty of The Wharton School at the University of Pennsylvania, in finding that in an insurance arrangement:

> *[T]he risk dimension that is being transferred is the unpredictability or variability of loss and not the expected loss or long run average cost.*[11]

The court further found that:

> *[T]he expected loss is the average loss expected to occur over a period of time. The insurance company charges a premium that will cover the expected loss. Thus the risk of the expected loss theoretically is not transferred, since the insured pays an amount through a premium that covers the expected loss.*

The court also relied on the testimony of Dr. Doherty with respect to the risk element in insurance in finding that, "Insurance protects against the variability of loss." The court further stated that:

> *An insured party pays a premium that is expected to cover the average loss. Therefore, the insured party does not transfer the cost of the average loss, since the insured party pays that amount to the insurer. What the insured party transfers to the insurer when it pays premiums is the cost of variability in losses. The risk that the insured transfers to the insurer is the variability of loss, not the complete loss from an event, such as a hurricane or accident, since the insured pays a premium that covers the average cost of the complete loss.*

The term "risk" may be broadly defined as uncertainty about an outcome and the possibility that the outcome will be unfavorable.

Thus, it is recognized as fundamental that the type of risk that insurance companies take on involves an element of expected loss, and further, that the only risk that is actually transferred is the variability in the amount of expected loss.

In Fundamentals of Risk and Insurance,[12] the authors examine risk from the perspective of the insurance company and similarly focused on the notion that the risk element in an insurance arrangement involves variability from expected experience. As discussed therein:

> *In the case of an insurer, actuaries predict some specified number and amount of losses and charge a premium based on this expectation. The amount of predicted losses is the desired outcome that is expected by the insurer. For the insurer, risk is the possibility that losses will deviate adversely from what is expected.*[13]

Pure Risk

The term "risk" may be broadly defined as uncertainty about an outcome and the possibility that the outcome will be unfavorable. The key elements under such definition are indeterminacy and loss. In an insurance context, risk is defined as a condition in which there is an exposure to a loss.[14] According to Fundamentals of Risk and Insurance,[15] risk is:

> *[A] condition in which there is a possibility of an adverse deviation from a desired outcome that is expected or hoped for.*[16]

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The Dictionary of Insurance Terms, defines risk as, "Uncertainty of financial loss." [17]

There appears to be universal acceptance that the specific type of risk involved, however, must be a "pure risk," as opposed to a "speculative risk." Although it may be actuarially possible in some instances to utilize insurance principles to cover a speculative risk, insurance risk does not generally contemplate, for example, a purchase of coverage against "putting it all on red" during your next trip to Vegas.

As the Ninth Circuit stated in *AMERCO*:

> *An insurance risk is the possibility that a particular event for which an insured will be held liable will occur. Of course, from the standpoint of the insured there can be no profit from that risk. The only possible outcomes are loss or no loss. It is that risk which must be transferred to the insurer if true insurance is to be involved.*

In other words, the key determinant as to whether a risk constitutes insurance risk is whether the risk is a "pure risk." This is evident as one views the insurance literature. Moreover, it has also served as the basis for determination under several judicial authorities that examined whether a particular transaction involved insurance.
See, for example, the Tax Court discussion in *AMERCO*, that quotes the experts for both parties, including Dr. David Cummins,[18] a witness for the taxpayer ("Insurance exists when the following elements are present: (1) Economically independent decision makers who enter into contracts to reduce the economic consequences of pure risk. …"); and the government's witness, Dr. Irving H. Plotkin ("Commercial insurance is a mechanism for transferring (or shifting) the financial uncertainty arising from specific pure risks."). In *Sears*,[19] the Tax Court again stated, "There [must be] a transfer of pure risk in form."

There appears to be universal acceptance that the specific type of risk involved, however, must be a "pure risk," as opposed to a "speculative risk."

George Lai and Robert Witt[20] surveyed several leading scholars on the type of risk that is relevant for determining whether insurance is present. They stated:

> *The first issue is which type of risk should be considered for insurance purposes: speculative risk or pure risk? Most insurance scholars agree that pure risk rather than speculative risk is the relevant risk to consider …*
>
> *as suggested by Cummins (1990), … pure risk, … is the relevant type of risk for evaluating traditional insurance transactions.*

A pure risk exists when there is a chance of loss but no chance of gain.[21] In contrast, "speculative risks" exist when there is a chance of gain as well as a chance of loss.[22] As the Ninth Circuit observed regarding this characteristic of an insurable risk, "Of course, from the standpoint of the insured there can be no profit from that risk."[23] In keeping with the statement of the court in *AMERCO* that, "The only possible outcomes are loss or no loss," it is the absence of the possibility of gain, not the certainty of some loss that is a necessary condition in order for a risk to be insurable. The Tax Court in Sears similarly explained:

> *Risk is present when the outcome of an event is uncertain or unknown. A pure risk is one in which the event can produce either a loss or a neutral outcome; there is no possibility of profit.*[24]

While there may also be actuarial complexities involved in covering a speculative risk—though it may be possible—the reason for this "loss or no loss" restriction is generally understood to be a practical one that relates, in part, to the consideration of possible moral hazards that might be encouraged by providing protection against the downsides of participating in unwanted, risky behavior.[25]

Pure Risk Includes Business Risk

As a footnote to this discussion, the IRS and Treasury have recently begun to include in the boilerplate language that they typically include in their pronouncements on insurance related items that, in order for an arrangement to qualify as insurance for federal income tax purposes, it cannot be used to cover business risks. For example, as stated in Rev. Rul. 2007-47, "The risk … must not be merely [a] … business risk."

It appears, however, that a business risk can be a pure risk, and thus, at least from a non-federal income tax standpoint, it may be covered by insurance. As discussed by John D. Long in his text, *Soft Spots in Insurance Theory,*[26] *Issues in Insurance*, with respect to business losses, Long quotes Herbert G. Grubel as stating that, "the risk of fire loss is not essentially different from risk of business loss." Long further observed that business risks are similar to all other pure risks, again quoting Grubel for the proposition that, "There are no a priori reasons for believing that business losses are uninsurable. …"

Also *see*, 1997 FSA 708, where the IRS stated:

> *[I]nsurance terminology generally distinguishes between speculative or investment risk, and pure risk. … Pure risk … refers to unsought burdens of business activity. … Pure risks may be covered by insurance. …*

Frequency (Occurrence) Versus Severity (Outcome)
It follows from the above discussion that in an insurance context, the range of possible outcomes relative to a given risk goes not just to the probability of occurrence of the risk, or frequency risk, but also to the severity of the risk. As discussed in Severity Risk and the Adverse Selection of Frequency Risk:[27]

> *Insurance actuaries typically model frequency of losses and severity of losses separately.*

As such, it would appear that from a non-tax perspective, the question noted above about whether an event that causes a loss or not has already occurred, is not determinative as to whether an arrangement involves insurance.

It is also apparent from the above that the courts recognize that the determinative risk characteristic is whether the risk is a "pure risk," as they have observed that insurance companies assume both "frequency" risks and "severity" risks. Based on the above, it would appear to be contrary to an understanding of insurance to suggest that risk is not insurable simply because an event has occurred when the outcome of that occurrence is not yet known. In other words, the concept of fortuity goes beyond mere uncertainty about an occurrence or happening. These authorities recognize that fortuity as to an outcome of an event, regardless of whether the event has occurred, can serve as the basis of an insurance arrangement.

As the court found in *Ocean Drilling*, while there is always an element of "expected" loss, insurance covers variability, both in terms of frequency and severity of loss.

This notion is bolstered by court decisions that have also addressed the relevance of the fact that an event causing the possibility of loss has already occurred. For example, in *AMERCO*,[28] there is language in the court's opinion that suggests that this fact does not eliminate the possibility that insurance could exist under such a scenario. It stated:

> *[A]n insurer accepts a premium and agrees to perform some act if* ***or*** *when the loss event occurs. [Emphasis added]*

The court's use of the term "or" indicates that insurance would exist even if there is no question that the loss event will occur; *i.e.*, the insurance company will perform "when" the loss event occurs. If the court had intended that the definition of insurance only contemplated transactions involving a contingency as to whether an event will occur, the above would have referred to performance by the insurance company "if **and** when" the loss event occurs, rather than "if **or** when."[29]

Prior IRS Guidance Involving Fortuity as to Outcome and Timing, But Not Occurrence
The IRS has also, on numerous previous occasions, recognized the insurance nature of arrangements that lacked fortuity as to the occurrence of a loss event, but not the ultimate amount or timing of loss.

For example, as discussed in GCM 39796, written in support of Rev. Rul. 89-96:

> *Although an insurer generally has no obligation as to losses from liabilities accruing before the term of its policy, "[n]o legal obstacle prevents parties, if they so desire, from entering contracts of insurance to protect against loss that may have possible [sic] already occurred."* United States v. Patryas*, 303 U.S. 341, 345 (1938).*

The position that a contract of insurance will be binding even when both parties were certain the prior loss occurred goes back to the earliest litigated cases on insurance. As further discussed in GCM 39796:

> *When both the insurance company and the policyholder are aware that the loss event has already occurred when they enter into the contract, the insurance company is bound under*

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the contract. See Merchants Mutual Ins. Co. v. Lyman*, 82 U.S. 664, 21 L. Ed. 246, 247 (1872), where the Supreme Court stated as follows:*

> *When the company came to make this instrument, they were entitled to the information which plaintiffs had of the loss of the vessel. If, then, they had made the policy, it would have bound them, and no questions would have been raised of the validity of the instrument or of fraud practiced by the insured*.

See also, General Ins. Co. of America v. Lapidus*, 325 F.2d 287, 290 (9th Cir. 1963) (insurer which, with warning that ground under house had already slipped, issued policy to the insured could not avoid liability for landslide loss);* Muller Fuel Oil Co. v. Insurance Co. of North America, *232 A2d 168, 176 (N.J. Super. Ct. App. Div. 1967) (If the prospective insured made full disclosure of the facts and was sold a policy with coverage against malicious prosecution upon the insurance company's representation that the policy afforded coverage with respect to the antecedent incident for which the prospective insured desired coverage against the potentiality of a malicious prosecution suit, then so long as no suit had commenced, there was no valid reason why the insured was not entitled to coverage as to that potential and uncertain risk. While an insurance company policy ordinarily would not insure against a malicious prosecution claim where the tortious conduct and the substantial injury predated the policy, it could do so if the parties to the contract understood and interpreted the policy to include coverage as to the not fully ripened antecedent incident.).*[30]

In 1997 FSA 708, the IRS looked to accounting guidance in discussing whether the policies at issue involved insurance risk. In that FSA, the IRS described the definition of "insurance risk" set forth by the Financial Accounting Standards Board (FASB) in Statement of Financial Accounting Standards No. 113 (the "FASB Statement"). The FASB Statement indicates that, for financial reporting purposes, "[I]nsurance risk is fortuitous—the possibility of adverse events occurring outside of the control of the insured." The FSA further defined insurance risk, again quoting from the FASB Statement, as "[t]he risk associated with the occurrence of the insured event under an insurance contract. Those risks include the uncertainties relating to both the ultimate amount of those payments and the timing of those payments."

By virtue of their focus on the timing and amount of the "payment," both the FASB and the IRS made clear that the key element to this analysis is the amount and timing of the ultimate loss emanating from a loss event, not from the event itself, and regardless of whether the event already occurred.

The FSA also contained a discussion of claims-made and occurrence-based policies. In doing so, the FSA stated that a loss event may occur either before or after an event occurs. Again, the unknown feature the FSA focused on was the loss. That is, in either case, it was irrelevant to the IRS that the event may have previously occurred, as the "losses are unknown at the time the contract is executed."

In addressing the result in Rev. Rul. 89-96, the FSA explains that the loss was known to both parties **and** that the loss was "fixed." Once again, the key element was the "payment," not the loss event. Thus, the fact that the loss event occurred in the past does not matter, so long as there is uncertainty regarding severity of the ultimate loss payment.

In a 1998 FSA, the IRS reiterated its position that the key element to this type of analysis is uncertainty relating to the ultimate amount of the loss payment, not the occurrence of the event. In that FSA—which deals with a similar situation of a case involving retroactive coverage—the Service provides in a footnote that risk may be transferred in a retroactive insurance arrangement when the insured and the insurer are not yet aware of the nature of the underlying claim.[31] The FSA is even more revealing with respect to the fortuity question, however, in that it states that the reason why risk being transferred is insurance is because, "There is enough uncertainty as to the amount of these losses to constitute risk transfer."

Reference should also be made to 1996 FSA 112 which provides a very clear example which demonstrates that when the amount of a prior loss is uncertain, coverage relating to a known event can still constitute insurance. The scenarios presented in that FSA involved a reserve set aside by an interstate trucking company to pay for

liability and worker's compensation claims. The FSA compares the losses at issue to the loss in Rev. Rul. 89-96, and states: "What is not legitimate insurance is the transfer of liabilities of known (or almost certainly predictable) amount." The FSA then establishes that the critical element for insurance is uncertainty as to amount, and provides the following:

> *For example, an employee of [text redacted] may have negligently caused a compensable injury on August 29, 1994, and at the time the contracts were executed the parties: (1) Were ignorant that the injury had occurred, (2) Knew the injury had occurred but were ignorant of the amount of the payment which would result, or (3) Knew it had occurred and estimated the amount of the payment, but their estimate was substantially lower than the eventual payment. Under any of those circumstances [text redacted] was assuming a risk, i.e., assuming the legal obligation to pay for unlimited losses of an unknown or unpredictable amount resulting from acts which occurred before the contract was executed.*

The IRS again states that a policy qualifies as insurance—even in an arrangement involving retroactive coverage—when the amount of the ultimate liability is not known.

> *To the extent that the liability was not known by one or both parties, however, there was an element of insurance in the contracts.*

By virtue of the numerous rulings set forth above that describe situations involving "retroactive" types of coverage, insurance of known, or certain losses, are common within the insurance industry. In fact, recently finalized Treasury regulations under Internal Revenue Code section 338 and section 1060[32] require that the assumption of known losses between insurance companies be treated as an insurance arrangement.

These rules were the subject of significant public attention for a period of several years as part of a process that involved a high degree of contention among taxpayers—who argued unsuccessfully for a different result. Under these regulations, when the target company of a transaction to which those regulations apply is an insurance company, the transaction shall be treated as an assumption reinsurance transaction. In the case of a property and casualty insurance company, the reserves on the financial

statements of the company reflect losses that have already occurred. This means that the Treasury's and the IRS's own regulations state that known, measurable losses not just "can" qualify as insurance, but that transfer of those losses "must" be treated as an insurance arrangement.

Timing Alone

The courts have also recognized that fortuity solely as to timing can be sufficient to meet the definition of insurance. For example in pre-section 7702 cases involving permanent life insurance contracts, this type of unpredictability was a determinative factor. That is, in a scenario involving life insurance, the amount of the loss may be known and the event giving rise to the loss—*i.e.*, death—is a certainty. The fact that the timing of a death cannot be predicted with certainty, however, was found to provide the element of fortuity necessary for an insurance risk to exist. This was the result reached by the Second Circuit in *Treganowan*, which found that the risk of premature death under a life insurance policy was an insurance risk. In that case, which is heavily relied on in Rev. Rul. 2007-47, the Second Circuit stated: "[E]ven death may be considered fortuitous, because the time of occurrence is beyond control."[33]

In situations like *Treganowan*, a premium cannot be determined to completely shield the insurer from the risk of loss caused by the premature death of a single insured, and thus, the timing of the loss payout can represent an insurance risk. This is similar to situations involving fortuity as to occurrence and outcome. In each case, the insurer is not able to limit its losses on a single risk based on the amount of the insurance premium that an insured would be willing to pay. Instead, the insurer limits its risk by spreading a single risk over multiple risks through the insurance principle of pooling.

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Moral Hazard

Certainly, in any situation where a loss may have already occurred, there is potential for moral hazard that would have an impact on the recognition of a contract as an enforceable insurance arrangement. This would occur, for example, in the event there is information asymmetry. This refers to situations where the insurance company and the policyholder are not equally—or at least both adequately—informed as to the facts material to the arrangement. The issue here is whether the policyholder possesses information regarding the condition of the insured item that would be material to the insurance company's willingness to enter into the arrangement.

For example, the fact that a prospective insured seeking automobile theft protection knew prior to entering into an insurance arrangement that the subject car was already missing, the policyholder's failure to inform the insurance company may provide the insurance company a defense against payment on a subsequent claim. If the parties were equally aware as to the missing automobile, then such defense may not be available.

Asymmetrical knowledge of an event does not, however, go to the issue of whether a particular risk is insurable. Rather, it is pertinent to whether a contract is voidable; *e.g.*, in a circumstance where information asymmetry enables a policyholder to fraudulently induce an insurance company to provide coverage. When there is no information asymmetry, however, a contract will be respected under the law, even if a loss has already occurred. The IRS has acknowledged this.

See, for example, the discussion above, quoting GCM 39796. There, the IRS distinguished among several cases where the parties were both fully informed of a prior loss event and knew with a great deal of certainty what the ultimate loss under the contract was going to be and those where the parties knew about the event but were uncertain as to the timing and amount of the ultimate claim. As was discussed above in further detail, in most cases, where the parties are fully informed as to the ultimate amount of a claim, there will be insufficient variability in outcome to permit the principles of pooling to be effective. In a case where the parties are unaware as to the timing and amount of a claim, the operation of pooling will continue unimpeded.

At the End of the Day …

After years of trying, taxpayers, the courts, the IRS and the Treasury have yet to articulate a precise standard for determining whether an arrangement should be treated as insurance for federal income tax purposes. Undoubtedly, that effort will continue, as it should. It should be carried out, however, in light of the fact that—absent the violation of some tax doctrine that would require looking through the form of a transaction—there is no authority to disregard as insurance an arrangement that is treated as such for non-tax purposes. That is, there is no authority to develop a tax-only definition of insurance.

Although a definition escapes simple reduction to prose, there are certain fundamental characteristics, or principles, that can be looked to as a guide for determining whether to characterize something as insurance. As discussed above, the initial inquiry should be whether the transaction is designed to protect against variances from expected experience. Next, there should be an analysis as to whether the subject risks are capable of being pooled such that the law of large numbers can be utilized to bring the ratio of actual to expected results near to one. Finally, there is the question as to whether the risks for which the protection is being sought are properly characterized as pure risks.

And yes, as the Treasury and the IRS suggest, in order for an arrangement to be respected as insurance, one would expect it to involve an element of fortuity. As further guidance is issued in this area, hopefully, additional clarification will be provided as to what this term means. ◂

How might the coverage of our plant clean-up costs be characterized under these standards? Are the owners seeking coverage against variances from expected costs? Could the operation of the insurance principle of pooling be effective in bringing the ratio of actual to expected expenses to one? Are the subject risks pure risks? Does the arrangement involve fortuity? Is there any tax reason why the form of an insurance arrangement to cover these risks should be disregarded?

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End Notes

[1] Moreover, through the application of the central limit theorem, the insurance company can determine the appropriate amount of premium to charge per unit of risk. That theorem asserts that the distribution of the average loss per risk unit in a large pool of risks converges to a normal distribution. Such average amount, by definition, would be less than the maximum possible loss per unit of risk.

[2] The ruling does not discuss whether similar types of coverage were being provided to other policyholders.

[3] Presumably, the existence of these contingencies provide a likely reason why the policyholder would seek to enter into an insurance arrangement of this nature.

[4] The facts of the ruling do not indicate that the policyholder would get a refund of any amounts in the event claims are less than the cost estimates.

[5] This was the case in three internal legal memoranda the IRS released for publication in the months before it issued Rev. Rul. 2007-47. ILM 200703007 (released January 19, 2007); ILM 200629028 and ILM 200629029 (both released on April 14, 2006). The approach and rationale applied in those IRS memoranda is identical to that applied in Rev. Rul. 2007-47. Despite some differences in facts not relevant to the IRS rationale, each of those memoranda involved the coverage relating to procedures anticipated to be required relative to the remediation of property damaged as the result of unknown amounts of pollution resulting directly or indirectly from the operation of nuclear power plants.

[6] That is, it is irrelevant if there was only one policyholder from a risk distribution standpoint. The determination as to whether there is sufficient risk distribution is based on the existence of a number of independent risks, not the number of policyholders. It is possible for a single contract to involve many independent risks upon which the principles of risk distribution can operate. It should be noted, however, that in recent guidance, the Service has indicated a different position on this issue. Such guidance has resulted in significant discussion within the insurance industry. If Treasury and the IRS contemplated that the arrangement in Rev. Rul. 2007-47 did, in fact, involve only one policyholder, query whether the ruling reflects a change in the government's stance? That is, under their theory, insurance tax treatment could have been denied on that basis alone, rather than having to even get into the question of fortuity.

[7] As discussed in the text above, a rational insurance company would not have entered into the arrangement unless it was able to pool the underwriting risks it was taking on, either through the pooling of the subject policyholder's risks with those of other policyholders not mentioned in the ruling, or through a pooling of the several independent risks inherent in the single arrangement described.

[8] *See* American Heritage Dictionary, Second College Edition, which recognizes the definition of an event as, "something that takes place, occurrence;" or "a significant occurrence or happening;" as well as the equally applicable definition which states that the term event also refers to "the actual outcome or final result."

[9] Dictionary of Insurance, Fifth Edition, Littlefield, Adams & Co. (1977). The full definition refers to "Uncertainty as to the outcome of an event when two or more possibilities exist." The possibility of more than two outcomes suggests that risk does not involve just whether an event occurs or does not occur.

[10] *Ocean Drilling and Exploration Company v. United States*, 988 F.2d 1135 (Fed. Cir. 1993), *affirming* 24 Cl. Ct. 714 (1991).

[11] *Ocean Drilling*, at p.43.

[12] Fundamentals of Risk and Insurance, Emmett J. Vaughan and Therese Vaughan, John Wiley & Sons, Inc., 9th Ed. 2003.

[13] Fundamentals of Risk and Insurance, at p.3.

[14] Risk Management and Insurance, Irwin McGraw Hill, Eighth Edition, C. Arthur Williams, Jr., Michael L. Smith, Peter C. Young. p 384.

[15] Fundamentals of Risk and Insurance, Emmett J. Vaughan and Therese Vaughan, John Wiley & Sons, Inc., 9th Ed. 2003.

[16] *Id.*, at p.3.

[17] Dictionary of Insurance Terms, Harvey W. Rubin, 2nd Ed., Barron's Educational Series, Inc. 1991. This is similar to the broad definition of risk contained in the Dictionary of Insurance, quoted in the text above ("Uncertainty as to the outcome of an event when two or more possibilities exist.").

[18] The court recognized Dr. David Cummins of The Wharton School at University of Pennsylvania, and his colleague Dr. Neil A. Doherty, mentioned in the text above, and who also testified in this and numerous other insurance tax cases, as being "accomplished, recognized insurance experts, conversant in the theory and practice of insurance."

[19] *Sears, Roebuck & Company v. Commissioner*, 96 T.C. 61 (1991), *supplemental opinion*, 96 T.C. 671, *affirmed on this issue and reversed on another issue,* 971 F.2d 858 (7th Cir. 1992).

[20] George C. Lai and Robert C. Witt, *The Tax Deductibility of Captive Insurance Premiums: An Assessment and Alternative Perspective*, Journal of Risk and Insurance, American Risk and Insurance Association Inc., Vol. 62, No. 2, 1995.

[21] Risk Management, p 7.

[22] *Id.* p. 8.

[23] *AMERCO*, 979F.2d 162 (9th Cir. 1992).

[24] *Sears*, 96 T.C. at 65.

[25] Risk Management, p. 384.

[26] John D. Long, *Soft Spots in Insurance Theory*, Issues in Insurance, Volume II, p.470.

[27] Doherty and Schlessinger, Severity Risk and the Adverse Selection of Frequency Risk, Journal of Risk and Insurance, vol. 62, No. 4, American Risk and Insurance Association, Inc. (December 1, 1995).

[28] AMERCO v. Commissioner, 96 T.C. 18 (1991), *aff'd*, 979 F.2d 162 (9th Cir. 1992).

[29] *See* also, *Harper Group v. Commissioner*, 96 T.C. 45, 58 (1991), *affirmed* 979 F.2d 1341 (9th Cir. 1992).

[30] *See* also, FSA 200043011 and 1998 FSA LEXIS 167.

[31] 1998 FSA Lexis 167.

[32] Unless otherwise indicated, all section references contained herein are to the Internal Revenue Code of 1986, as amended.

[33] *Treganowan*, 183 F.2d at 290, *citing*, 8 Ency.Soc.Sc. 95.

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