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COMMON SENSE, INSURANCE IN THE COMMONLY ACCEPTED SENSE, AND TAM 201149021

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OVERVIEW

The federal income tax case law's definition of insurance is well-established, if not consistently applied. In order for an arrangement to qualify as insurance, the arrangement must (i) involve an insurance risk, (ii) involve both risk shifting and risk distribution, and (iii) constitute insurance in the commonly accepted sense.[1] Beginning in the 1960s, the Internal Revenue Service (IRS) devoted extraordinary resources to the second prong of this test, seeking to disqualify as non-insurance those arrangements that, in the IRS view, lacked risk shifting or risk distribution.[2] Those efforts met with limited success, and in the first decade of the 21st century the IRS generally retreated on how the requirements of risk shifting and risk distribution would be applied in the context of related parties.[3] The IRS did not retreat more generally, however, on other issues that arise in the context of unrelated parties. In addition, the IRS's acknowledgement of its litigation losses on risk shifting and risk distributing necessarily puts pressure on the application of the lesser-developed elements of the definition of insurance.

Given this background, it is not surprising that, in TAM 201149021, the IRS took another tack in contesting purported insurance arrangements, concluding that residual value insurance did not qualify as insurance for federal income tax purposes. The authors argue that the standard for what is "insurance in the commonly accepted sense" was misapplied in the TAM, and that, in any event, the accounting regime imposed by the IRS produces a significant distortion of the taxpayer's income.

BACKGROUND

The characterization of an arrangement as "insurance" has significant consequences for the protection buyer (the policyholder) and the protection seller (the insurer). For the protection buyer, an insurance premium paid is generally deductible, even though economically the premium may be more akin to a prepayment of amounts that otherwise would not yet be deductible because they do not yet meet the all-events and economic performance requirements of section 461. For the protection seller, premium income is generally recognized over the period of coverage, and losses incurred are generally deducted on a reserve basis, even though payment might not be made for years. Because insurance premiums are deductible, whereas amounts set aside for self-insurance are not deductible, the IRS has historically fought to prevent the characterization of arrangements as insurance for federal income tax purposes, except for the most straightforward, commercially common arrangements.

The Internal Revenue Code Defines the Term "Insurance Company," but Does Not Define What Is an Insurance Contract

Section 816(a) defines the term "life insurance company" as an insurance company that is engaged in the business of issuing life insurance and annuity contracts or noncancelable accident and health insurance contracts, if its life insurance reserves comprise more than 50 percent of its total reserves. For this purpose, a company is an insurance company if more than half the business of the company during the taxable year is the issuing of insurance or annuity contracts or the reinsuring of risks underwritten by insurance companies.[4] Under section 831(c), the same definition applies in the case of a non-life insurance company.

Although the definition of insurance company requires that a taxpayer be in the business of issuing insurance or annuity contracts, the Internal Revenue Code (the "Code") does not define the term "insurance contract." Rather, the analysis of whether an arrangement is an insurance contract for federal income tax purposes generally depends on the application of federal income tax case law.

This analysis typically begins with a citation to *Helvering v. LeGierse*, 312 U.S. 531 (1943). In *LeGierse*, an elderly woman purchased a life insurance policy, naming her daugh-

ter as beneficiary; however, before accepting the policy, the life insurance company required the elderly woman to enter into a lifetime annuity contract. Based on the interdependency of the life insurance and annuity policies, the Supreme Court determined that the insurance company effectively held offsetting positions, thus neutralizing its "insurance" risk. Consequently, a true insurance arrangement did not exist between the policyholder and the insurance company. In defining "insurance," the Supreme Court noted:

> We think … that the amounts must be received as the result of a transaction which involved an actual "insurance risk" at the time the transaction was executed. Historically and commonly insurance involves risk-shifting and risk-distributing…. That these elements of risk-shifting and risk-distributing are essential to a life insurance contract is agreed by courts and commentators.

After the Supreme Court's decision in *LeGierse*, other courts (generally citing *LeGierse* and generally in the context of life insurance) applied a similar standard.[5]

Historically, the IRS Has Attempted To Limit the Definition of "Insurance" Administratively

As early as 1960, the IRS examined a purported insurance arrangement among policyholders who owned real estate in the same floodplain. The ruling, Rev. Rul. 60-275, 1960-2 C.B. 43, concluded the arrangement lacked the requisite risk distribution, because a single flood would cause losses for all policyholders. Thus, the risks were not statistically independent.[6]

In the mid-1970s, the IRS stepped up its activity in the area and in Rev. Rul. 77-316, 1977-2 C.B. 53, for the first time pronounced the "economic family theory." The ruling discussed situations where purported insurance premiums are paid by a domestic parent corporation and its domestic subsidiaries to a wholly owned foreign "insurance" subsidiary of the parent under an insurance arrangement. The ruling concluded that the foreign subsidiary was not an insurance company as the arrangement may not be respected as insurance for tax purposes because it is within the same economic family. The basic theory of the IRS, which came to be known as "the economic family theory," was that there is no economic shifting or distributing of risks of loss if the insurer and insureds are economically related.

By 2000 and 2001, the Exam function of the IRS was dutifully and consistently citing Rev. Rul. 77-316 and disallowing the insurance characterization of arrangements between a taxpayer and other members of the same economic family. Appeals was dutifully and consistently evaluating the hazards of litigating these cases, and in many cases signing off on full concessions.[7]

No court, however, fully accepted the economic family theory articulated in Rev. Rul. 77-316. In 2001, the IRS formally abandoned the economic family theory and promised to apply a facts and circumstances test to determine whether an arrangement that purported to qualify as insurance for federal income tax purposes in fact met the standards of the relevant case law.[8]

Since 2001, the IRS has provided a series of helpful rulings that are best described as safe harbors for determining whether an arrangement among related parties has the requisite risk shifting and risk distribution to qualify as insurance. In Rev. Rul. 2002-89, 2002-2 C.B. 984, the IRS analyzed arrangements between a domestic parent corporation and its wholly owned subsidiary that constituted insurance. The ruling concludes that the amounts paid by a domestic parent corporation to its wholly owned insurance subsidiary are not deductible as insurance premiums if the parent's premiums are not sufficiently pooled with those of unrelated parties. The ruling also effectively provides a safe harbor under which a parent-subsidiary arrangement will be respected as insurance if at least 50 percent of the insurer's business represents unrelated risks. In Rev. Rul. 2002-90, 2002-2 C.B. 985, the IRS concluded that payments for professional liability coverage by a number of operating subsidiaries to an insurance subsidiary of a common parent constituted insurance, as long as no single operating subsidiary contributed more than 15 percent or less than 5 percent of the total risks assumed by the insurance subsidiary. The ruling also effectively provides a safe harbor under which arrangements among an insurer and at least 12 sibling operating companies may constitute insurance. In Rev. Rul. 2002-91, 2002-2 C.B. 991, the IRS described circumstances under which amounts paid to a group captive of unrelated insureds are deductible as insurance premiums and in which the group captive qualifies as an insurance company.

In addition, the IRS has elaborated on its position that an arrangement cannot qualify as insurance if only the risks of a single policyholder are pooled. Rev. Rul. 2005-40, 2005-2

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C.B. 4, sets forth four circumstances under which an operating company with a large number of statistically independent, homogeneous risks entered into an "insurance contract" with an unrelated, intended insurance company. In Situation 1, the arrangement did not qualify as insurance because the insurer did not enter into contracts with any other policyholders; in the view of the IRS, risk distribution was not present. Consistently, in Situation 2, the arrangement did not qualify as insurance because 90 percent of the insurer's business was that of a single policyholder. In Situation 3, insurance contracts entered into with 12 unrelated single member LLCs did not qualify as insurance contracts because the single member LLCs were disregarded for federal income tax purposes and all treated as a single entity. Situation 4 was the same as Situation 3, except that the single member LLCs were not disregarded, and the arrangements accordingly had sufficient risk distribution to qualify as insurance.

Rev. Rul. 2005-40 was followed up with an assurance in Rev. Rul. 2009-26, 2009-2 C.B. 366, that the IRS would not apply its single-insured position in the context of a reinsurer that enters into a single contract with a single ceding company, provided the underlying block of business represents a sufficiently large number of unrelated primary insureds.[9]

Insurance Risk

One of the conditions of insurance is that the risk transferred must constitute an insurance risk. There is, however, no tax definition of insurance risk. The courts and the IRS have thus either pronounced their own independent standards or turned to economic and legal definitions.

In *Allied Fidelity Corp. v. Commissioner*, 66 T.C. 1068, 1074 (1976), aff'd, 572 F.2d 1190 (7th Cir. 1978), cert. denied, 439 U.S. 835 (1978), the Tax Court wrote that insurance risk is a risk of "a direct or indirect economic loss arising from a defined contingency," so that an "essential feature of insurance is the assumption of another's risk of economic loss."

In *AMERCO v. Commissioner*, the Ninth Circuit stated:

> The 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. Speculative risk, on the other hand, is merely investment risk, and it can produce profit or loss.

In a Litigation Guideline Memorandum,[10] the IRS stated:

> Businesses face hazards that expose them to adverse but uncertain financial consequences. These hazards are referred to as pure risks or insurable risks (in contrast to investment or speculative risks). A "pure risk" is defined by one of the government's trial experts, Dr. Irving H. Plotkin, as a risk that can only have bad or neutral results. See The Harper Group v. Commissioner, T.C. Docket No. 33761-85, Report of Irving H. Plotkin, p.7. An example of a pure risk is a fire or accident. A speculative or investment risk can have good, bad, or neutral results. An example of a speculative risk is the risk of whether a profit or loss will be generated from the conduct of a business or by taking a position on foreign currency. The insurance industry generally does not offer products to manage these types of risks. R. Riegel, J. Miller, & C. Williams, Insurance Principles and Practices: Property and Liability 2 (6th ed. 1976). Only a pure risk is an insurable risk (also known as an insurable interest). When this type of risk is transferred to an insurance company, the insured has relieved itself of the financial uncertainty concerning the consequences of an event. In the hands of the insurer, however, the pure risk of the insured has become an investment risk; will the loss cost more or less than the accumulated premiums and investment earnings?

Note, it is unclear how the IRS believes this analysis distinguishes investment risk from insurance risk. For example, one would expect an insurer to undertake the same comparison of expected loss versus premiums and investment earnings when evaluating an arrangement that clearly qualifies as insurance.

In Rev. Rul. 89-96, 1989-2 C.B. 114, the IRS denied the insurance characterization of a contract on the basis that merely investment risk was transferred to the insurer. The ruling considers a situation where a catastrophe occurs in June 1987, imposing a liability on the taxpayer "substantially in excess" of \$130. The taxpayer has insurance coverage of \$30. In July 1987, the taxpayer purchases additional "insurance" of \$100. The ruling concludes that the transaction involved only investment risk and not insurance risk. The IRS stated that there are two elements to the ruling which eliminate insurance

risk. First, the loss has occurred, and second the anticipated liability ($130+) exceeds the total coverage ($30 + $100). Since the anticipated liability is substantially in excess of the total coverage, the full amount of the coverage will be paid. Thus, there is no risk regarding the amount payable, but only the period over which it will be paid. The ruling concludes that the risk elements borne by the insurance company were a timing risk (that the $100x would have to be paid out earlier than anticipated) and an investment risk (that the actual investment yield would be lower than forecast). The ruling concludes that these risks are not insurance risks.

It is also commonly understood that insurance is the mechanism to manage the risk of loss from fortuitous events. APPLEMAN ON INSURANCE 2d, section 1.4 provides

> Fortuity is another key element in determining what constitutes insurance for purposes of legal classification. It would be foolhardy for insurance companies to sell insurance that would pay for losses strictly within an insured's control…. This is the point where the concept of fortuity comes into play. Insurance is designed to cover the unforeseen or at least unintentional damages arising from risks encountered in life and business: injuries and damages caused by negligence and other similar conduct where the insured stands to sustain a real and palpable loss (generally pecuniary) as a result of the event for which the insurance has been purchased.

The IRS thus followed up on Rev. Rul. 89-96 with Rev. Rul. 2007-47, 2007-2 C.B. 127, which concludes that an arrangement that provides for the reimbursement of inevitable future costs does not involve the requisite insurance risk for purposes of determining (i) whether the amount paid for the arrangement is deductible as an insurance premium and (ii) whether the assuming entity may account for the arrangement as an "insurance contract" for purposes of subchapter L of the Code. In that ruling, the costs at issue were environmental cleanup costs that were certain to be incurred in the future, but uncertain as to timing and amount. Important to the analysis of Rev. Rul. 2007-47 was a premium amount and a policy limit that established that, economically, the "premium" paid under the arrangement represented a prefunding of known future costs.

The facts of Rev. Rul. 2007-47 do not include a risk transfer analysis of the sort often undertaken for regulatory and accounting purposes. The insurance risk requirement, however, also means that the insured must have exposure to an actual, economic loss. In *Group Life & Health Ins. Co. v. Royal Drug Co.*, 440 U.S. 205, 211 (1979), the Court explained that risk shifting entails the transfer of the impact of a potential economic loss from the insured to the insurer. If the insured has shifted its risk to the insurer, then a loss does not affect the insured because the loss is offset by the proceeds of an insurance payment. Similarly, in *Epmeier v. United States*, 199 F.2d 508, 509-10 (7th Cir. 1952), the term "insurance contract" was defined as "a contract whereby, for an adequate consideration, one party undertakes to indemnify another against loss from certain specified contingencies or peril…. [I]t is contractual security against possible anticipated loss."

Insurance in the Commonly Accepted Sense

The analysis of the third prong of the traditional insurance analysis—insurance in the commonly accepted sense—is less developed than the other prongs of the traditional three-prong insurance analysis.

On the same day it decided *AMERCO* , articulating the familiar three-prong standard for what constitutes insurance, the Tax Court also decided *The Harper Group v. Commissioner,* 96 T.C. 45, 58 (1991), aff'd, 979 F.2d 1341 (9th Cir. 1992). In *The Harper Group*, the court elaborated on what constituted insurance in the commonly accepted sense. Specifically, the court enumerated the following factors to support a conclusion that arrangements entered into by an international shipping firm qualified as insurance: (1) the insurer was both organized and operated as an insurance company; (2) the insurer was regulated as an insurance company by the relevant local regulator; (3) the premiums under the arrangements were the result of arms-length transactions; and (4) the arrangements at issue were valid and binding. Apart from these factors, there is little guidance about what constitutes insurance in the commonly accepted sense, and the IRS's efforts to equate this with a "fortuity" requirement and apply its independent notion of what satisfies this have met with some controversy.[11]

It is also commonly understood that insurance is the mechanism to manage the risk of loss from fortuitous events.

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TAM 201149021

The taxpayer in TAM 201149021 was in the business of issuing residual value insurance ("RVI") contracts, and filed a federal income tax return as a non-life insurance company. Under the RVI contracts, the taxpayer received an up-front premium in exchange for the taxpayer's obligation to pay the excess (if any) of the originally projected future (residual) value of a leased asset over the fair market value of the asset at the end of the lease term. The leased assets included passenger vehicles, commercial equipment and commercial real estate that the protected parties leased to third parties. The lengths of the contracts differed according to the lives of the assets; some had a 10- to 25-year term.

The contracts were issued only to policyholders with an economic interest in the asset (presumably the property lessors). Taxpayer's obligation to make a residual value payment matured at the end of the contract term. If taxpayer made a residual value payment, the agreement provided that the taxpayer was either subrogated to the protected party's rights with respect to the covered asset or received title to the covered asset.[12] The taxpayer treated the residual value insurance contracts as insurance contracts for federal income tax purposes, and accordingly took the position it was an insurance company subject to tax under subchapter L.

The IRS disagreed with the taxpayer's position that the contracts were insurance contracts. According to the IRS, the residual value insurance contracts lacked insurance risk, lacked risk distribution, and did not constitute insurance in the commonly accepted sense.

It is possible the IRS felt constrained to reach this conclusion in order to avoid line drawing, or to avoid expanding the definition of insurance to encompass other instruments, such as financial products that are not otherwise governed by existing authorities. In taking the approach that it chose, however, the IRS likely reached the wrong conclusion, and in any event traded one set of unintended consequences for another.

Insurance Risk Requirement and Risk Shifting and Distributing

In the TAM, the IRS noted, citing *Commissioner v. Treganowan*, 183 F.2d 288, 290-91 (2d Cir. 1950), "Insurance risk requires a fortuitous event or hazard and not a mere timing or investment risk." The IRS then observed that the contracts generally do not protect against damage to the particular asset; instead, they protect against market forces that depress the value of the protected asset at the end of the term. It then concluded that this type of risk is more akin to an investment risk than to an insurance risk. The IRS also concluded that the event that triggers the taxpayer's liability is the termination of the contract. It noted that contract termination is not the type of event that gives rise to a casualty event.

In the RVI contract, the loss was defined as the excess of the predicted residual value of the protected asset as set forth in the contract over the fair market value of the asset at the end of the lease term. The protected party would either be reimbursed for the full amount of its loss or not. If the protected party suffered a loss, it would be reimbursed for that loss, up to the coverage limits of the agreement. As the taxpayer either was subrogated to the protected party's rights with respect to the covered asset or received title to the covered asset, the loss was crystallized as of the termination date, and the protected party may not profit from the insurance proceeds by then selling the covered asset for an amount greater than the amount used to determine the payment received under the RVI contract. The contract itself, through its valuation mechanism, provided reasonable assurance that the loss reflected true market conditions as of the termination date.

The taxpayer also argued that risk distribution was achieved under its policies because the taxpayer insures a multitude of residual value risks of numerous unrelated insureds. The IRS disagreed, observing in the TAM that the taxpayer cannot sufficiently utilize the law of large numbers to distribute its risk among the protected assets to achieve risk distribution in its commonly defined sense. Citing Rev. Rul. 60-275, 1960-2 C.B. 43, the IRS noted that the protection contracts protect against market forces that depress the value of the protected asset. If the market forces are significant, such as a sufficient unemployment rate, the value of most, if not all, protected assets could be depressed. To the extent that the termination dates of the contracts are sufficiently close in time or that the contract applies to pools of assets, the interdependence of the risks supports the examining agent's position that there is no risk distribution. On the other hand, the TAM did not explain how multiple classes of assets, ranging from passenger vehicles to commercial equipment and real estate, and with lives of less than 10 years in some cases to 25 years in others, could be interdependent in the way the floodplain policyholders' risks were interdependent in Rev. Rul. 60-275.

Insurance in the Commonly Accepted Sense

The portion of TAM 201149021 that concludes residual value insurance is not insurance in the commonly accepted sense is six paragraphs long and contains no citations to legal authorities.

It begins by acknowledging a number of factors that should have weighed in favor of concluding the arrangements are insurance in the commonly accepted sense:

- The taxpayer filed NAIC annual statements and was regulated as an insurance company by the various jurisdictions in which it was licensed;
- The contracts were issued in the form of insurance contracts;
- The contracts have provisions that are typically found in insurance policies;
- The protected parties have an ownership interest (i.e., an insurable interest) in the underlying property; and
- The taxpayer paid premium taxes on the amounts received as premiums.

The TAM nevertheless rejected the taxpayer's characterization of the arrangements as insurance in the commonly accepted sense because the losses, if any, resulted from a decline in asset value. According to the TAM, for an arrangement to constitute insurance in the commonly accepted sense, "a casualty event and damage or impairment in some form is required…. While there are insurance policies that may be influenced by a decline in asset value, the insurance company's obligation under these policies still rests on a casualty event and the casualty must cause the decline in value."

The TAM's approach in this regard makes it difficult for taxpayers to anticipate whether the IRS will agree that a particular contract constitutes insurance in the commonly accepted sense and hence may qualify as insurance for federal income tax purposes. In fact, the TAM's analysis raises more questions than it answers:

> Does the TAM's analysis conflate the "insurance risk requirement" and the "insurance in the commonly accepted sense" requirements, applying its independent concept of "casualty" for both purposes?
>
> Stated differently, does the IRS still follow the three-prong analysis of AMERCO and The Harper Group, or in the IRS's view is the "insurance risk" prong really a part of "insurance in the commonly accepted sense"?
>
> Does the IRS believe it matters whether an arrangement satisfies the The Harper Group factors for insurance in the commonly accepted sense—why did it not cite the case?
>
> Is the IRS's notion of insurance in the commonly accepted sense a subjective, "know it when I see it" standard? See, e.g., Jacobellis v. Ohio, 378 U.S. 184 (1964) (applying such a standard to pornography).
>
> If the IRS can reject the insurance characterization of an arrangement that is regulated as insurance and satisfies the standard applied by the Tax Court in The Harper Group, how are taxpayers to anticipate whether, in the view of the IRS, a new or innovative insurance product can ever meet the third prong in AMERCO for insurance characterization?
>
> Although the regulation of an arrangement as insurance is not in itself determinative, wouldn't the IRS have been better off with an approach that demonstrated some degree of deference to the state regulation of an arrangement as insurance, provided no other tax accounting regime applied?

WHETHER OR NOT THE ARRANGEMENTS ARE INSURANCE, THE APPLICABLE METHOD OF ACCOUNTING SHOULD CLEARLY REFLECT INCOME

Absent a specific provision to the contrary, an important responsibility of both taxpayers and the IRS is to apply the Code in a way that achieves a clear reflection of income. This responsibility is implicit in the administration of a tax on income (versus, for example, a tax on gross receipts). It is an element of the tax system's fairness and legitimacy. And, in the long run, it prevents manipulation by taxpayers who benefit by deferring income and accelerating deductions, or vice versa. In fact, the accounting provisions of general application explicitly require a clear reflection of income.[13] In the case of gross income, section 451 requires that an amount of any item of gross income be included in gross income in the taxable year in which received unless, under the method of accounting used in computing taxable income, the amount is to be properly accounted for as of a different period.[14]

Absent a specific provision to the contrary, an important responsibility of both taxpayers and the IRS is to apply the Code in a way that achieves a clear reflection of income.

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In the TAM, a single premium was paid up-front for coverage to be provided over a number of years. Would one expect a clear reflection of income to require such a single payment to be matched with either the period of coverage or the deduction for related claim payments? The TAM did neither, but instead reported all premium income up-front (when received), and deferred all deductions until the end of the contract term (when paid out).

Subchapter L Would Have Recognized Premium Income Ratably as It Was Earned

If the IRS had concluded that the residual value insurance contracts were insurance contracts for federal income tax purposes, the gross premiums written during the taxable year would have been included in gross income (in their entirety) in the first year. The taxpayer would have been permitted a deductible unearned premium reserve under section 832(b)(4), which would have had the effect of recognizing premium income over the term of the contract.[15] Gross income thus would have been neither front-loaded nor back-loaded. Correspondingly, one would ordinarily expect the policyholder's deduction for that premium payment to be recognized ratably over time, and the IRS had previously so concluded. Specifically, in TAM 9830001, the IRS concluded that the premium paid for residual value insurance coverage over a period of years was to be deducted ratably as an insurance premium over the period of the contract. The 1998 TAM did not question whether the residual value insurance qualified as insurance for federal income tax purposes.

Consistently, if the TAM had concluded that the residual value insurance contracts were insurance contracts, deductions would have been allowed at a time and in an amount that arguably are best matched to the relevant periods. Under section 832(b)(5), a deduction would have been permitted for losses paid during the year, and for the change in a reserve for unpaid losses. The reserve for unpaid losses would have been maintained on a discounted basis with regard to losses incurred.[16] Deductions would have been allowed for amounts determined to be "fair and reasonable." The regime for deductions thus would have complemented the regime for recognizing premium income.

Bunching income into the year of receipt, and bunching deductions into the year of payment—sometimes many years later—might make sense in other areas, but not where a pool of income is collected from unrelated parties and used to satisfy fortuitous events. In this sense, subchapter L would have provided a clear reflection of both issuer's income and deductions with regard to the residual value insurance contracts. The TAM, however, ruled out this approach by concluding the contracts were not insurance contracts, and with little explanation imposed the most onerous possible accounting regime: reporting all income at the beginning of the contract term, and all deductions at the end.

Analogously, existing authorities produce a clearer reflection of income with regard to other types of products.

A. If the contracts had been puts, the relevant authorities would have matched gross income to the related items of deduction.

In the case of a put, IRS guidance establishes an accounting regime that clearly reflects income of the issuer, albeit in a manner different from that applied to insurance contracts under subchapter L.

Rev. Rul. 78-182, 1978 1 C.B. 265, sets forth rules for taxing both the writer and the holder of a put or a call. For the writer (issuer) of a put, a wait-and-see approach is prescribed. That is, the premium received for writing the put is not included in income at all, but is carried in a deferred account until the obligation expires, or until the issuer purchases the underlying asset pursuant to exercise of the put, or until the transaction otherwise closes. The ruling further explains the application of section 1234(b) (which applies only to options involving stock, securities or commodities), and sets forth the rule that if the issuer purchases the underlying property pursuant to the holder's exercise of the put, the premium received decreases the issuer's basis in the underlying property.

Because the contracts in the TAM were likely insurance contracts, they were not puts and not governed by Rev. Rul. 78-182. However, the wait-and-see approach of Rev. Rul. 78-281 would have provided a clearer reflection of income under the facts of the TAM than the income-up-front approach that the TAM prescribed. In the case of residual value insurance, the profitability of the transaction is unknown at the time the contract is entered into. In circumstances where the basis is known but the gross income is not yet known, courts apply the "open transaction doctrine" of *Burnet v. Logan*, 283 U.S. 404 (1931), permitting the full recovery of basis before any income is recognized.[17] The TAM presents the inverse. That is, gross income (premiums) is known, but the extent of future deductions (claims) is unknown at the time the contract is en-

tered into. If a goal of tax policy and a measurement of clear reflection of income is the matching of income and deductions, the wait-and-see approach of Rev. Rul. 78-182 would achieve a clear reflection of income under the facts of the TAM. The approach of the TAM takes exactly the opposite approach, taxing gross income in some cases two decades before the related deductions are allowed. A mismatch that spans such a long period of time is not only distortive as a matter of the time value of money, but also eliminates any possibility that net operating losses generated by those deductions could be carried back to the year in which the related premiums were earned.

Treating the residual value insurance contracts as puts would have been more advantageous to the taxpayer in the TAM than the insurance contract accounting that the taxpayer had claimed. That is, taxation as a put would have deferred all premium income until the last year of the contract, rather than recognize it ratably over time. Although it is unimaginable that the IRS was unaware of this alternative characterization, the TAM does not acknowledge it.

B. If the contracts had been notional principal contracts, income would have been more clearly reflected.

Closely related to the economics of a put are the economics of a notional principal contract. Both are financial products under which the rights and obligations of the issuer and holder are determined by reference to the value of underlying assets.

Again, because the arrangements in the TAM were likely insurance contracts, they were not notional principal contracts and not governed by section 1.446-3. Moreover, as a technical matter, the contracts described in the TAM are not notional principal contracts under the notional principal contract (NPC) regulations. Section 1.446-3(c) of the regulations defines a notional principal 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. A futures contract, a forward contract, and an option are excepted from the definition. Because the contracts in the TAM entailed only a single payment, up-front, by the policyholder, and a single payment by the insurer at the end of the contract term if the value of the underlying assets declined sufficiently, the contracts in the TAM do not fall within the current definition of notional principal contract.[18]

In general, the goal of the NPC regulations is to achieve a clear reflection of income of the parties to a notional principal contract. The regulations do so by distinguishing among periodic payments, nonperiodic payments and termination payments. The parties to a notional principal contract must recognize each year the ratable daily portions of both periodic payments for the taxable year (under section 1.446-3(e)) and nonperiodic payments for the taxable year (under section 1.446-3(f)) to which those portions relate. Termination payments are recognized under section 1.446-3(h) in the year the contract is extinguished, assigned or exchanged. In this way, the regulations avoid the result in the TAM, recognizing as income or deduction in each taxable year the portion of each payment that is related to that year.

In sum, the NPC regulations would almost necessarily provide a clearer reflection of income than the methodology prescribed in the TAM.

C. Could any other method have applied?

Even if the contracts were not insurance contracts, one might reasonably ask whether the IRS could have exercised its general authority under section 446 to achieve a clearer reflection of income under the facts of the TAM.

Section 446 provides the general rule for taxpayers' methods of accounting. Under this provision, taxable income generally is computed under the method of accounting on the basis of which a taxpayer regularly computes income in keeping its books. If no method of accounting has been regularly used, or if the method used does not clearly reflect income, the computation of taxable income must be made under a method that, in the opinion of the Secretary, does clearly reflect income. Section 446 explicitly permits the use of the cash method or accrual method of accounting, or any other method or combination of methods permitted under the Code and regulations, subject to the overall requirement that the method clearly reflect income.

In sum, the NPC regulations would almost necessarily provide a clearer reflection of income than the methodology prescribed in the TAM.

Thus, even if the IRS was correct that the contracts at issue in the TAM were not insurance contracts for federal income tax

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purposes, and even if they were not puts, the IRS may have had authority to permit the use of a method that reflected income more clearly than the method it imposed in the TAM. In fact, the IRS exercised its authority to prevent up-front recognition of insurance income in Rev. Proc. 97-38, 97-2 C.B. 479, where it instead permitted taxpayers to use the Service Warranty Income Method (SWIM) to recognize such income over time as related deductions were recognized. It is possible that IRS did not do so in the TAM because it felt such a method would first need to be authorized by published guidance such as a regulation, revenue ruling or notice. What is clear is that the method set forth in the TAM matches the premium income of the taxpayer with neither the period it is earned nor the deductible expenses that relate to it. Under the facts of the TAM, the mismatch with regard to some contracts may be as great as 25 years.

HOW MIGHT THE ANALYSIS IN THE TAM APPLY TO OTHER FORMS OF INSURANCE OR REINSURANCE?

It is likely that the IRS opted not to treat the residual value insurance contracts as insurance to avoid sweeping into subchapter L a variety of financial products not heretofore acknowledged as insurance by the IRS.[19] Despite the narrow view of insurance evidenced in the TAM, the IRS is unlikely to challenge the insurance characterization of arrangements that are already widely recognized as insurance, such as title insurance, surety insurance, life insurance, ocean marine fleet insurance, marine "total loss only" insurance, underground storage tank liability insurance, crop insurance and financial guaranty insurance. In fact, the TAM goes to great lengths to distinguish several of these types of insurance on the basis of a casualty event that triggers liability.

Other types of insurance for which the IRS has previously expressed skepticism may be no closer to resolution as a result of the TAM's analysis. For example, the IRS has previously expressed skepticism on the insurance characterization of finite risk transactions and loss portfolio transfers.

In Notice 2005-49, 2005-2 C.B. 14, the IRS asked for comments on four insurance-related legal issues, including finite risk transactions. At the time, finite risk transactions were in the news due to uncertainty about the standards for determining when such transactions should be accounted for insurance and when such transactions should be accounted for as financing arrangements. Although no published guidance resulted from this request for comments, useful comments were received, some of which urged deference to the determination of a state insurance regulator that sufficient risk was transferred to qualify an arrangement as insurance.[20] The TAM's subjective approach to what constitutes "insurance in the commonly accepted sense," its failure to acknowledge the standards for this determination in *The Harper Group*, and its reluctance to defer to state insurance regulation, leave taxpayers with little guidance on how the IRS would propose to draw the line between transactions that qualify as insurance and those that do not.

Likewise, the IRS's view of a pure loss portfolio transfer is no closer to resolution as a result of the TAM's subjective analysis of what constitutes insurance in the commonly accepted sense. In Rev. Rul. 89-96, 1989-2 C.B. 114, the IRS held that a purported insurance contract based on a catastrophe that already had occurred did not qualify as an insurance contract for federal income tax purposes. Important to the ruling's analysis was the fact that under the contract it was reasonable to expect that the amount of net premium received, plus the amount of tax savings, plus the investment income earned on these amounts, would probably exceed the maximum liability under the contract. Consistently, in Rev. Rul. 2007-47, 2007-2 C.B. 127, the IRS concluded that a purported insurance contract based on an environmental remediation liability that was sure to be incurred (albeit at an unknown time and in an unknown amount) was not an insurance contract. Again, important to the ruling's analysis was a policy limit that would be reached or not reached based on the timing of any claim payment and investment performance of the insurer. Neither ruling considers what result would obtain if the contract entailed sufficient risk shifting to be treated as insurance for regulatory and accounting purposes, and the policy limit were so high that the likelihood of reaching it was remote. The TAM's subjective view of "insurance in the commonly accepted sense" leaves unanswered what standard the IRS would apply in such a case.

CONCLUSION

Whether or not it is correct, the conclusion in TAM 201149021 represents a predictable move by a tax administrator concerned with line drawing and unintended expansion of subchapter L accounting to new and different areas. In this sense, the TAM is not a surprise.

It is unfortunate, however, that the IRS cited no legal authorities to support its assertion that an arrangement that apparently satisfies the requirements of *The Harper Group*

nevertheless does not qualify as insurance in the commonly accepted sense. Taxpayers are left with little guidance as to how the IRS might apply the prong in other cases.

It is also unfortunate that, in its efforts to exclude less-traditional insurance products from subchapter L, the IRS denied the taxpayer in this case an accounting regime that would have provided a clear reflection of income. In fact, the TAM seems to go out of its way not only to keep the contracts out of subchapter L, but also to impose an onerous accounting regime that demonstrably front-loads income to a large degree. It was unnecessary for the TAM to do so.

Going forward, practitioners need to consider whether the TAM's approach poses potential for whipsaw. For example, are policyholders and companies whipsawed where a multi-year premium payment is fully included in income under the logic of TAM 201149021, but the corresponding deduction by the policyholder is deferred under the logic of TAM 9830001? Is the government whipsawed when an insurance company that needs taxable income (such as to prevent NOLs or other tax attributes from expiring) enters into this line of business with regard to long-life assets? Most importantly, does the TAM represent a different standard for the clear reflection of income of a taxpayer that is regulated as an insurance company? The merits of the TAM will be debated for a long time.

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END NOTES

[1] Although *Helvering v. LeGierse*, 312 U.S. 531 (1941), is the landmark case most often cited as the starting point for analyzing what is insurance for federal income tax purposes, the three-prong test is often associated with *AMERCO v. Commissioner*, 96 T.C. 18 (1991), aff'd 979 F.2d 162 (9th Cir., 1992).

[2] *See, e.g.,* Rev. Rul. 60-275, 1960-2 C.B. 43 (the "flood plain" ruling); Rev. Rul. 77-316, 1977-2 C.B. 53, obsolete by Rev. Rul. 2001-1 C.B. 1348 (first articulating the "economic family" theory).

[3] Rev. Rul. 2001-31, 2001-1 C.B. 1348 (obsoleting several revenue rulings and explaining that IRS would no longer raise the "economic family theory" in addressing whether an arrangement constitutes insurance).

[4] *See also* section 1.801-3(a) (promulgated in 1960 when the relevant test was "primary and predominant" rather than "more than 50 percent," the regulation makes clear that it is the character of the business actually done during the taxable year that determines whether a company is taxable as an insurance company).

[5] *See, e.g., Estate of Walter C. Burr v. Commissioner*, 156 Fed.2d 871 (2d Cir., 1946), *certiorari denied* 329 U.S. 785, and *Estate of Eustace R. Conway v. Glenn,* 193 Fed.2d 965 (6th Cir. 1952), both applying *LeGierse* for their analysis.

[6] The rationale of Rev. Rul. 60-275 was specifically rejected in *U.S. v. Weber Paper Company*, 320 F.2d 199 (8th Cir. 1963) which held, on similar facts, that once the premium deposits had been made taxpayer had relinquished its dominion and control over the funds and therefore the amounts were deductible in the year of payment. In Rev. Rul. 64-72, 1964-1 C.B. 85, the IRS restated its position in Rev. Rul. 60-275 and announced it would not follow the decision in *Weber Paper.*

[7] *See, e.g.,* FSA 200105014 (Oct. 26, 2000); FSA 200043012 (Oct. 27, 2000); FSA 200125005 (June 22, 2001); FSA 200125009 (June 22, 2001); FSA 200029010 (July 21, 2000).

[8] Rev. Rul. 2001-31, 2001-1 C.B. 1348.

[9] In addition, by analogy, *see* Theodore R. Groom letter to the IRS, dated May 11, 2011, recommending that published guidance confirm that, under Rev. Rul. 9293, 1992-2-C.B. 144, distinguishing the single-insured analysis of Rev. Rul. 2005-40 from a company's insurance of certain employee benefits under a medical stop-loss arrangement. Tax Analysts Doc. 2011-11073.

[10] 1990 LGM TL-85 (Jan. 24, 1990).

[11] *See, e.g.,* Gelfond, Frederic J., *Fortuity, or not Fortuity? ... That is the Question, Taxing Times* (September 2008).

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

[13] See, *e.g.,* section 446(b) (If the method of accounting regularly used by the taxpayer does not clearly reflect income, the computation of taxable income must be made under a method that, in the opinion of the Secretary, does clearly reflect income.); 1.446-1(a)(2) ("A method of accounting which reflects the consistent application of generally accepted accounting principles in a particular trade or business in accordance with accepted conditions or practices in that trade or business will ordinarily be regarded as clearly reflecting income, provided all items of gross income and expense are treated consistently from year to year.")

[14] In the case of personal service income, this rule is generally applied to mean up-front inclusion in income even for a contract that extends beyond the end of the taxable year. *See Schlude v. Commissioner,* 372 U.S. 128 (1963). *But see* Rev. Proc. 97-38, 97-2 C.B. 479 (IRS commissioner's exercise of discretion to permit the use of the service warranty income method, rather than the up-front income inclusion required under *Schlude v. Commissioner*, to account for amounts received as premiums for service warranties on durable goods such as automobiles).

[15] Under section 832(b)(4)(A) and (B), the unearned premium reserve would have been subject to a 20 percent haircut, which is a proxy for capitalizing acquisition costs.

[16] When a loss is treated as "incurred" for this purpose is a different issue and beyond the scope of this article.

[17] The open transaction doctrine is generally applied sparingly. *Warren Jones Co. v. Commissioner,* 524 F.2d 788 (9th Cir., 1975); *McShain v. Commissioner,* 71 T.C. 998, 1004 (1979).

[18] Regulations proposed in September 2011 would modify this definition. At least one insurance trade association commented on the proposed modification, expressing concern that if the proposed regulations were finalized in their current form, some traditional insurance contracts could fall within their scope. Walter Welsh and Peter Bautz letter on behalf of the American Council of Life Insurers, dated Dec. 14, 2011 (Tax Analysts Doc. 2011-26810).

[19] Notice 2004-52, 2004-2 C.B. 168, analogized credit default swaps to insurance contracts. Regulations proposed in September 2011 would explicitly reject insurance characterization and would add credit default swaps to the list of swaps categorized as notional principal contracts governed by the rules of section 1.446-3. 76 Fed. Reg. 57684 (Sept. 16, 2011).

[20] *See, e.g.,* Brenda Viehe Naess letter on behalf of the Reinsurance Association of America (RAA) and the National Association of Mutual Insurance Companies (NAMIC), dated Oct. 3, 2005.