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IRS RULES THAT INSURANCE AGAINST DECLINE IN ASSET'S MARKET VALUE IS NOT INSURANCE FOR TAX PURPOSES

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In TAM 201149021, the Internal Revenue Service (the "Service") National Office has ruled that an insurance contract that insures against a decline in market value of assets leased to third parties is not an insurance contract for federal income tax purposes. Consequently, for these contracts, the Taxpayer must use § 451 and § 461 of the Code to determine the taxable year for which items of gross income are included and the taxable year for which deductions are taken.

Neither the Internal Revenue Code nor the Income Tax Regulations define the terms "insurance" or "insurance contract." The standard for evaluating whether an arrangement constitutes insurance for federal tax purposes has evolved over the years and is, at best, a nonexclusive facts and circumstances analysis. In a trilogy of cases (*Sears, Roebuck & Co. v. Commissioner*, 96 T.C. 61 (1991); *The Harper Group v. Commissioner*, 96 T.C. 45 (1991); and *AMERCO v. Commissioner*, 96 T.C. 18 (1991)), the Tax Court stated that insurance involves "presence of insurance risk," "risk shifting and risk distributing," and "commonly accepted notions of insurance." In the TAM, the Service applied this three-part test and concluded that the arrangement is not insurance because it lacks insurance risk, it is not insurance in the commonly accepted sense, and it lacks risk distribution.

FACTS

The Taxpayer, a domestic property and casualty insurance company, enters into insurance contracts with unrelated parties (the "protected parties") that lease passenger vehicles, commercial equipment and commercial real estate (the "protected assets") to third parties. The protected parties enter into the contacts with Taxpayer to protect against a decline in the value of the protected assets over the term of the lease. Under the contracts, Taxpayer must pay a protected party an amount equal to the difference between the predicted residual value of the protected asset and the actual fair market value at the end of the lease term ("residual value payment").

The lease terms vary, and in some cases are as long as 25 years. Taxpayer issues the contracts in a form that is commonly accepted as insurance, with standard insurance policy provisions, and includes requirements that the protected party maintain an ownership interest in the protected asset from the time the contract is entered into until the end of the lease term. At the end of the lease term, the protected asset's fair market value is determined based on actual sales price, appraisal or other specified method. In consideration for Taxpayer's obligation, the protected parties make a payment to Taxpayer when the contract is signed.

There is no requirement for the protected party to show that the decrease in the final value of the protected asset resulted from any particular cause, and the contracts specifically list general economic downturns and advances in technology as potential factors in the contracts' non-exclusive list of possible causes. When a protected party submits a payment request to Taxpayer's claims department, Taxpayer verifies that the party has an ownership interest in the asset and that the terms and conditions of the contract have been satisfied.

INSURANCE RISK

The Service stated: "Not all contracts that transfer risk are insurance policies even where the primary purpose of the contract is to transfer risk. For example, a contract that protects against the failure to achieve a desired investment return protects against investment risk, not insurance risk." As support, the usual cases and rulings were cited for the proposition that the risk transferred must be more than a mere investment risk (*Helvering v. LeGierse*, 312 U.S. 531 (1941), *Securities and Exchange Commission v. United Benefit Life Insurance Co.*, 387 U.S. 202 (1967), Rev. Rul. 89-96, 1989-2 C.B. 114, Rev. Rul. 68-27, 1968-1 C.B. 315, Rev. Rul. 2007-47 and 2007-30 C.B. 1277). The Service also stated that an insurance risk requires a fortuitous event or hazard and not a mere timing or investment risk. The Service, perhaps correctly, notes that a fortuitous event (such as a fire or accident) is at

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the heart of any contract of insurance. However, they again fail to acknowledge that fortuity can not only be relative to the occurrence of the event, but can also be relative to the magnitude of the loss.

The contracts at issue contemplate a projected decline in value over the term of the contract and then provide protection against the actual value at the end of the contract being lower than that projected value. The contracts generally do not protect against damage to the particular asset. Instead, the contracts protect against market forces that depress the value of the protected asset (and other similar assets) at the end of the term. The Service concluded that the contracts provided protection that the insured will receive less than its projected income from the protected asset at the end of the lease and that this type of risk is more akin to an investment risk than to an insurance risk.

INSURANCE IN THE COMMONLY ACCEPTED SENSE

In several decisions, the Tax Court has stated that for a contract to be treated as an insurance contract for federal tax purposes, the arrangement must be "insurance in its commonly accepted sense." However, neither the Tax Court nor any other authority has provided a thorough explanation of what is meant by insurance in its commonly accepted sense. In the TAM, the Service, citing no precedent or legal basis for doing so, provided its interpretation of the phrase "insurance in its commonly accepted sense" by initially stating that the phrase does not mean that all products sold by insurance companies are insurance policies. The tax treatment of a product at issue should be decided by legal relationships and not by the number of product sellers or the amount of product sales. The fact that other companies offer contracts similar to those at issue in this case does not change their conclusion.

After an analysis of known insurance products, the Service concluded that a factor found in insurance contracts that weighs heavily in this case is that insurance policies protect against damage or impairment to an asset or income from an asset caused by a casualty event. With respect to the residual value insurance, the Service concluded that the insurance company's obligation did not arise because of an event that damages or impairs the protected asset or its income stream. The contracts ensure that the projected income from the sale of the assets will not be reduced because of market forces. The risk is the unexpected market forces, but the occurrence of these events is not the casualty event. Unfavorable market changes may occur during the term of the contract without creating any liability. The event that triggers the insurance company's liability is the termination of the contract. Then, after noting all of the contract's features that are commonly found in insurance policies, and without citing any legal precedent, the Service concluded that the contracts are not insurance in the commonly accepted sense because contract termination, apparently even when coupled with the occurrence of the unexpected market forces for which protection is sought, does not give rise to a casualty event.

RISK DISTRIBUTION

Risk distribution is frequently cited as a fundamental requirement for insurance. However, there is little authority that discusses what is meant by risk distribution. Generally, risk distribution has been described as requiring both a large number of risks and risks that are independent of one another. The Service addressed interdependent risks in Rev. Rul. 60-275, 1960-2 C.B. 43, where a number of insureds pooled their premiums for coverage of assets all subject to the same flood risk. The Service concluded that risk distribution was not present; reasoning, in part, that a major flood would affect all properties involved because all properties were located in the same flood basin. The ruling stated that there was little likelihood that the subscribers would share any risk.

The TAM extrapolated from the very localized flood basin situation to a nationwide venue and without giving much weight to the myriad asset-specific, class of asset, local and regional factors impacting value, concluded that the better factual argument was that the risks insured under the contracts were interdependent. This conclusion was based on the assertion that the insurance company could not sufficiently utilize the law of large numbers to distribute its risk among the protected assets to achieve risk distribution in its commonly defined sense. No legal, actuarial or statistical basis or methodology was referenced or described as either support for the conclusion or as providing any guidance for the application of this approach.

IMPLICATIONS OF THE RULING

The TAM addresses an issue for which there is little, if any, guidance that is on point. This is the first, and likely not the last, attempt by the Service to distinguish between contracts that transfer an economic risk of loss that they wish to treat as insurance contracts for federal tax purposes and those that they do not wish to treat as insurance contracts for federal tax purposes. While the TAM addresses residual value insurance contracts, the type of analysis used by the Service could have broader implications.

Having concluded that the contracts are not insurance contracts, the Service states, without analysis, that the premiums received by the insurance company are subject to §451 income recognition rules, and losses paid by the insurance company are subject to the §461 all-events and economic performance rules. Thus, with no discussion of the proper matching of income and expense, the Service has created a situation where the "premium" could be fully taken into income up front and the related expense up to 25 years later. The Service did not discuss other possible accounting methods that could be applied to the transaction; for example, whether the contracts could be accounted for using the tax accounting rules applicable to option contracts.

The views expressed are those of the authors and not of Ernst & Young LLP.

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