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Investment Risk and the Limits of Insurance

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In LTRs 201609008 (Dec. 3, 2015) and 201613016 (Dec. 28, 2015), the IRS issued final adverse determinations that two P&C insurance companies did not qualify for tax-exempt status as small insurance companies under section 501(c)(15). The companies offered a rather novel line of insurance products for businesses in addition to more traditional products. Under the products, the businesses could insure themselves against the costs of suffering a public relations crisis, having to comply with new regulations, and even losing a key customer. The IRS, however, held that these products did not qualify as insurance under the tax law, reasoning that the products protected against "investment risk" and not "insurance risk." As a result, the companies did not qualify as insurance companies and could not obtain tax-exempt status.

The IRS' determination letters repeated a set of factors, first articulated in CCA 201511021 (March 13, 2015), that distinguish investment risk from insurance risk and could become the basis for applying the investment risk test going forward. While prior law has defined insurance risk as requiring something more than mere investment risk, this new analysis makes the presence of investment or business risk a significant factor in disqualifying an arrangement as insurance for tax purposes. Hence, in the IRS' view, even if a contract contains the requisite "insurance risk," the presence of substantial investment or business risks may prevent the product from counting as insurance under the tax law.

THE NATURE OF INSURANCE

The Internal Revenue Code in fact does not define "insurance." Instead, the courts and the IRS have acted to fill the void. In the seminal case of *Helvering v. Le Gierse*,[1] the Supreme Court decided that Congress intended the term insurance to be understood in its "commonly accepted sense." As a result, an insurance contract must protect against "insurance risk," which the court said consists of two essential elements: "risk-shifting" and "risk-distributing." The court also noted that the risk involved in that case was only an "investment risk," like the kind assumed by a bank, rather than an "insurance risk." While the court made this comment about investment risk primarily as a side note, this comment has given rise to a separate prong of the test for insurance contract status. A contract will not qualify as insurance even if it contains risk shifting and risk distribution if it does not also contain insurance risk, rather than mere investment risk. Later jurisprudence has summed up the definition of insurance with a three-prong test: (1) an insurance transaction must involve insurance risk, (2) it must involve risk-shifting and risk-distributing, and (3) in the absence of a statutory definition, it must be defined in its commonly accepted sense.[2]

The IRS emphasized the distinction between "insurance risk" and "investment risk" again in Rev. Rul. 89-96.[3] In that revenue ruling, the insurance contract covered a catastrophe that had already occurred. Questions remained, however, as to how much liability would be incurred and when it would come due. The insurance company agreed to cover the loss, up to a stated amount. In denying the contract insurance status for tax purposes, the IRS observed that the amount of the premium, the investment returns on the premium, and the tax savings from qualifying as an insurance contract "would probably exceed" the maximum amount payable under the contract. The IRS noted that the transaction did not contain the necessary risk shifting because the company only took on "investment risk," specifically the risk that it would not receive sufficient investment returns either because the liability would come due too soon or because it would receive a lower than expected investment return. Under Rev. Rul. 89-96, the risk appeared to the IRS to be insufficient where the only question was whether the invested premiums would generate sufficient returns to cover the future costs.

The test for "insurance risk" evolved in Rev. Rul. 2007-47.[4] In this revenue ruling, an insurance company agreed to foot the cleanup costs for a high-polluting business activity once the activity ended. Like Rev. Rul. 89-96, the covered event was certain to occur but questions remained as to when the costs would have to be paid and what investment returns the company would receive in the interim. Unlike Rev. Rul. 89-96, however, a major question existed as to the extent of costs that would accrue. The contract limited the total payout, but the limit appears to exceed the projected total cost by a significant margin.[5] Thus, the risks were not strictly investment risk in the common meaning of the term. Still, in the IRS' view, the risks assumed by the company lacked the requisite "fortuity," since the costs were certain to occur. The IRS found this fact sufficient to conclude that the coverage was not insurance under the tax law.

In CCA 201511021, a captive insurance company provided insurance against currency fluctuations to other members of the taxpayer group. In fashioning its position seemingly without tax precedent, the IRS "submit[ted] that all of the facts and circumstances associated with the parties in the context of the arrange-

ment should be considered." The CCA listed a set of factors to "take into account": (1) the ordinary activities of a business enterprise, (2) the typical activities and obligations of running a business, (3) whether an action that might be covered by a policy is in the control of the insured within a business context, (4) whether the economic risk involved is a market risk that is part of the business environment, (5) whether the insured is required by a law or regulation to pay for the covered claim, and (6) whether the action in question is willful or inevitable. Thus, instead of looking for the presence or absence of fortuity, the IRS applied a totality of the circumstances test. Based on this test, the IRS concluded that the contracts covering currency fluctuations contained investment risk and not insurance risk.

BEYOND "FORTUITY"

LTRs 201609008 and 201613016 appear to confirm that the IRS continues to apply the factor approach laid out in CCA 201511021. Importantly, these rulings show that the factor test has major substantive differences from the test that exists in court cases and official IRS guidance to date.

As noted above, in its prior rulings the IRS looked for the contracts to shift certain types of risk, specifically "fortuity" and not mere "investment risk," to treat the contracts as insurance under the tax law. This approach, however, cannot explain the results reached in the adverse determination letters. For example, one policy in the new letters covered any tax liability above the amount on a filed tax return prepared and signed by a CPA. The IRS found the policy to have only investment or business risk, not insurance risk, even though it clearly contained fortuity. While a tax return signed by a CPA has a significant chance of showing the correct tax due, in which case the policy would pay out nothing, the tax return also has some chance to understate tax and cause the insurance to pay out proceeds. Another policy provided insurance against the loss of a major customer, although the policy would not cover the loss if the insured initiated the termination or did not attempt to replace the customer. Here again, a significant fortuity exists that the business would lose the customer and incur a financial loss for reasons beyond its control. These policies would seem to pass the test outlined in Rev. Ruls. 89-96 and 2007–47.

Perhaps even more significantly, following the IRS' reasoning, the presence of certain types of investment or business risk coverage appears able to disqualify a contract as insurance for tax purposes, even where it otherwise contains the requisite insurance risk. One of the products in the letters covered the involuntary loss of a key employee if the loss resulted from the sickness, disability, death, loss of license, or retirement of the employee. The contract did not provide coverage if the insured fired the employee. Here again, the policy contains fortuity. The key employee could continue working for the insured, but may not do so if one of the covered conditions occurs. The IRS noted that a policy covering the death or disability of the employee would qualify as insurance. However, the contract involved also covered investment or business risks, such as the loss of license or retirement of the employee. As a result of covering these other risks, the IRS held that the contract did not qualify as insurance under the tax law. Based on the letters' reasoning, it appears that a contract covering both business risk and insurance risk does not qualify as an insurance contract. This result cannot be squared with the insurance risk test that currently exists in precedential guidance.

Treating investment risk as a disqualifying factor would fundamentally shift the nature of the insurance risk test to one that is comparative in nature. Instead of asking whether sufficient insurance risk exists in the product, the IRS' approach asks whether the risk present more closely resembles an insurance risk or an investment risk. The Tax Court recently rejected such an approach in *R.V.I. Guaranty Co. v. Comm'r*[6] in deciding that residual value insurance had the requisite insurance risk to qualify as insurance for tax purposes. The IRS argued, among other things, that the products contained only investment risk because they resembled a put option on stocks. Like put options, the product paid out proceeds to compensate for an asset's loss in value below a certain level. The Tax Court rejected this argument and stated that "courts have long held that a product can be 'insurance' even though competing products exist in the financial market place."[7] As such, an insurance product can look like a financial product, even act in the same manner as common financial products, without losing its characterization as insurance for tax purposes. Also worth noting, the Tax Court appears to be moving away from the fortuity approach. The decision notes the existence of a fortuitous event but appears to base its conclusions on a broad analysis of state law and expert testimony. This kind of analysis tends to imply a "facts and circumstances" approach and resists a bright-line rule that previous guidance has tried to create.

Examining the products in the letters, it is noteworthy that many of these products have little to do with "investment risk" in the common usage of the term. By its nature, investment risk refers to the uncertainty of the returns from investing money and the chance that the investment will lose some or all of its value. Many of these products, however, involve no real investment risk, beyond the time between when the premiums are paid and when the insurance becomes payable. For example, one of the products offered coverage in the event of a public relations crisis. The policy included a defined series of incidents that would constitute a public relations crisis. But does a public relations crisis constitute an investment risk? This seems unlikely. A public relations crisis would presumably hurt a shareholder's investments in a company, but it does not directly affect the company's investments. To frame the issue another way, if a high profile individual—such as a celebrity or politician—purchased public relations insurance, the risk would be entirely detached from any

investment. Reputation, rather than investment or even profit, would be on the line.

Unlike the currency fluctuation coverage in CCA 201511021, the products in the determination letters really cover business risk, not investment risk. A PR crisis, the loss of a key customer, and the loss of a key employee are business risks rather than investment risks. In the determination letters, the IRS appears to be drawing a line between the events covered by insurance and the risk that a business undertakes on a day-to-day basis. The IRS, it seems, has framed the issue as the contracts' assumption of "investment or business risk" because no precedent exists for disqualifying an insurance contract as such merely because it covers a business risk. To make sense of these results, however, it is necessary to view "business risk" as something different than the "investment risk" prong as it currently exists, perhaps even as a new prong of the insurance risk test.

Indeed, the "investment risk" prong of the Supreme Court's test in *Helvering v. Le Gierse* would need a fundamental change to act as it does in the determination letters. Far from a disqualifying fact, the Supreme Court has held that investment risk can be an important aspect of an insurance product.[8] Treating investment risk as disqualifying an insurance product would turn this result on its head. Thus, the investment risk test is being applied in the determination letters in a fundamentally different and even contradictory manner than it has in the past.

In sum, a significant problem is posed by the approach the IRS has taken in the determination letters. Using a totality of the circumstances test like this one has the effect of defining insurance as it currently exists, because new features or coverage would make a product look less like insurance as traditionally conceived of. Adhering to such an approach risks constraining future innovation within the insurance industry. Such a route should never be taken lightly. In the words of Supreme Court Justice William O. Douglas, "[I]nsurance is an evolving institution. Common knowledge tells us that the forms have greatly changed even in a generation. And we would not undertake to freeze the concepts of 'insurance' or 'annuity' into the mold they fitted when these Federal Acts [the securities laws] were passed."[9]

A COMMENT ON CONTEXT

Up until now, this article has sidestepped the context that gave rise to this issue. In theory, the context should have no bearing on the IRS' analysis and would only distract from understanding the IRS' application of the insurance risk test. In practice however, the situation here may involve transactions that the IRS views as abusive of the tax law, and this abuse may have influenced the IRS' conclusions.

The primary issue in the determination letters was whether the companies issuing the products qualified as small insurance companies tax exempt under section 501(c)(15). Based on the above analysis, the IRS concluded that the products sold by the companies were not insurance products and therefore the companies did not qualify as insurance companies under section 816(c), leading to denying their applications for tax-exempt status.

The companies, however, only sold the insurance products to affiliated corporations, specifically those companies held by the same group of owners. The owners appeared to have set up the company and issued the insurance contracts to take advantage of the tax exempt status allowed for small insurance companies.

The IRS may not take such a strict position as it has in the determination letters in more traditional situations where an insurance company seeks to offer new products to the general public. Additionally, of course, the determination letters discussed here are not precedential, and so they do not bind other taxpayers, nor do they bind the IRS in future matters. Even so, the decisions announced and the rationales offered in these determination letters appear to signal a new stage in the IRS' development of the insurance risk test. ■

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ENDNOTES

1. 312 U.S. 531 (1941).
2. *See, e.g.*, AMERCO, Inc. v. Comm'r, 979 F.2d 162, 165 (1992).
3. 1989-2 C.B. 114.
4. 2007-2 C.B. 127.
5. The revenue ruling omits the likelihood that the total costs of cleanup would exceed the contractual limit. This is interesting because the pivotal fact in Rev. Rul. 89-96 was that the costs were likely to exceed the contract limits, giving the contract a defined payout and making it look more like an investment contract than an insurance contract. Here however, the contract appears to have been fairly priced, with a premium set at the present value of the expected future costs. The limit on the contract was set at twice the premium paid.
6. 145 T.C. No. 9 (Sept. 21, 2015).
7. *See id.* at 23 (Slip opinion).
8. *See* Sec. and Exch. Comm'n v. Variable Annuity Life Ins. Co., 359 U.S. 65 (1959); Sec. and Exch. Comm'n v. United Benefit Life Ins. Co., 387 U.S. 202 (1967).
9. *See* Sec. and Exch. Comm'n v. Variable Annuity Life Ins. Co., 359 U.S. 65, 70 (1959).