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Tax Contours of Insurance Refined: *RVI v. Commissioner*

By Jean Baxley and Sheryl Flum

In September 2015, the Tax Court issued its opinion blessing residual value insurance[1] contracts as "insurance" for federal income tax purposes.[2] The contracts at issue in the case cover lessors and lenders against the risk that the actual residual value of an asset, i.e., its value when returned at the end of the lease period, will be significantly lower than the expected residual value of the asset at the outset of the lease. The *RVI* decision signals the Tax Court's willingness to acknowledge that nontraditional lines of coverage can pass muster as insurance for tax purposes.

This article provides a brief backdrop to the "what is insurance" issue, summarizes the Tax Court's opinion in *RVI*, and offers observations regarding some of the potential implications of the decision.

THE "DEFINITION" OF INSURANCE

In the tax context, the Internal Revenue Code ("Code") and Treasury regulations don't define insurance. This lack of a tax-tailored definition of "insurance" may be appropriate given that insurance products are constantly evolving and are generally subject to state (and sometimes federal, e.g., Securities and Exchange Commission (SEC)) regulatory oversight.[3] Whether a contract constitutes insurance affects, among other things, whether the insurance company can carry insurance reserves, whether the insured can deduct the premium paid for coverage (e.g., for business property-casualty covers), and whether inside buildup (e.g., life insurance cash values) can grow free of current taxation.

In the life context, Code section 7702 provides a detailed test for qualification as a life insurance contract. There are no such tax-specific guidelines for non-life insurance products.

There are plenty of litigated cases and numerous Internal Revenue Service (IRS) revenue rulings, technical advice memoranda (TAMs), and other guidance that address the topic of what constitutes insurance. But as product offerings change, it is difficult for insurance companies and the IRS to keep up with a working definition of "insurance." Ultimately, the question of whether a certain product or contract constitutes insurance for tax purposes is a fact-intensive inquiry that does not easily lend itself to bright-line tests and precise definitions. Over time, the contours of a common law tax "test" for what constitutes insurance have emerged, which broadly speaking involves one form or another of these factors: presence of insurance risk; risk shifting or risk transfer from insured to insurer; risk distribution (insurer pools and spreads many independent risks); and insurance in its "commonly accepted" sense.

THE FACTS IN *RVI*

During 2006, the tax year at issue, R.V.I. Guaranty Co. Ltd ("RVIG") was a Bermuda-domiciled insurance company that had in effect an election under section 953(d) to be taxed as a U.S. insurance company for federal income tax purposes. RVIG was regulated as an insurance company. RVIG's subsidiary, RVI Insurance Company of America ("RVIA") was a U.S. property-casualty insurance company. RVIA was licensed and regulated in, and sold policies in, seven states. RVIA and RVIG file a consolidated federal income tax return on Form 1120-PC, with RVIG as the parent company.[4]

RVIA's business consisted solely of issuing residual value insurance policies (the "RVI Policies") to customers. RVIA's customers were property leasing companies, manufacturers and financial institutions that financed leases of the covered real and personal property. RVIA was not the only insurance carrier issuing this type of coverage; other major carriers also issued residual value coverage. But unlike these other major carriers, RVIA was a monoline issuer. RVIA ceded to RVIG most of its risk on the RVI Policies.[5]

The RVI Policies protect the insured from a greater than expected decline in the value of the covered leased assets, i.e., the risk that a covered leased asset's value when returned at the end of the lease period will be significantly lower than the expected residual value that was determined at the outset of the lease. The amount insured under an RVI Policy is the difference between the actual value of the insured asset at the end of the lease and the insured value. The insured value is set below the expected residual value, i.e., the insured retains some of the risk on the difference between the actual and expected residual value. The expected residual values for covered assets were determined taking into account regular wear and tear.

At lease termination, RVIA determines whether a loss has occurred with respect to the covered leased property and, if so, the amount of the covered loss.

RVIA wrote three types of policies: (1) FASB policies, which were designed with insured value levels just high enough to allow the lessor to apply direct financing lease accounting under SFAS 13; (2) primary policies, for which the insured value is not tied to lease accounting; and (3) hybrid policies, under which each asset is covered by both FASB and primary coverage. Pricing for coverage under an RVI Policy ranged from 50 cents per $100 to $4 per $100 of insurance protection. The customer

typically paid a single upfront premium for coverage. Some, but not all, of the RVI Policies involved a deductible to be paid by the insured.

The properties covered by the RVI Policies represented three business segments: (1) commercial real estate (including 15 types of properties, e.g., retail stores, warehouses, motels), (2) passenger vehicles (including 20 types of automobiles, e.g., pick-up trucks, sedans, SUVs), and (3) commercial equipment (including aircraft, industrial equipment and rail cars). Each segment represented approximately one-third of RVIA's business, as measured by relative unearned premium at 2006 year-end. Lease terms of the covered properties ranged from one to five years (for vehicles) to up to 28 years (for real estate).[6]

RVIA treated the RVI Policies as insurance for statutory accounting purposes under Statement of Statutory Accounting Principles 62R ("SSAP 62R"), which requires that the insurer assumes significant risk and has a reasonable possibility of a significant loss from the insurance that it issues.[7]

RVIA's annual loss ratio (paid losses (including loss adjustment expenses) to earned premium) for 2006 was 33.2 percent; its cumulative loss ratio from 2000 through 2006 was 27.7 percent; its cumulative loss ratio from 2000 through 2013 was 34 percent.

The IRS challenged the insurance status of the RVI Policies for tax purposes based principally on the assertion that the insured lessors and lenders who purchased the RVI Policies were purchasing protection against an "investment" risk rather than an insurance risk—although during briefing and the trial the IRS also argued that the RVI Policies failed other prongs of the common law test for insurance.[8] Based on its investment risk theory, the IRS concluded that RVIA and RVIG were not insurance companies for tax purposes and assessed an income tax deficiency of approximately $55 million for the 2006 tax year.

THE TAX COURT'S ANALYSIS

The Tax Court, in its opinion, identifies the characteristics of insurance as (1) risk shifting, (2) risk distribution, (3) commonly accepted notions of insurance, and (4) the presence of insurance risk; discusses each characteristic; and concludes that the RVI Policies constitute "insurance" for federal income tax purposes. These four characteristics are discussed in the order in which they are set forth in the opinion.

(1) Risk Shifting

The risk shifting prong of the insurance test is handled in fairly short order, with the court observing that "insurance must be examined from the perspective of both the insurer and the insured."[9]

Tax Court's risk shifting standard (paraphrased): The court concludes essentially that an arrangement involves risk transfer from the insured's perspective if the insured externalizes its risk of financial loss by paying the insurer a premium. From the insurer's perspective, risk transfer has occurred if SSAP 62R is satisfied.

Outcome of Tax Court's analysis: Viewing the arrangement from both perspectives, the court has "no difficulty concluding" that a meaningful risk of loss was transferred from the lessors and finance companies that purchased the RVI Policies to RVIA.[10] The court finds that the RVI Policies satisfy risk shifting because the lessors and lenders that purchased the RVI Policies transferred to RVIA (and, consequently, RVIG through reinsurance) a meaningful risk of loss. The court notes that without the residual value coverage provided by RVIA, the lessors and lenders would bear the entire risk of a substantial drop in a covered leased asset's value at the end of the lease term when the asset was returned to the lessor or lender.

Support for Tax Court's conclusion: The court notes that RVIA was "indisputably" well-capitalized and in a position to absorb risks and pay claims.[11] Emphasis is also placed on the fact that the RVI Policies were reported as insurance for statutory accounting purposes under SSAP 62R, which requires the insurer to assume a significant risk under the contract and face a reasonable possibility of incurring a significant loss. Furthermore, the court points out that the IRS' expert committed a methodological error by limiting his analysis of losses to years prior to and including 2006. Many of the RVI Policies had experienced no losses as of 2006—and could not have experienced such losses—solely because the applicable lease terms for the insured properties had not yet expired, i.e., it was too early to know whether there would be losses on these policies. In de-bunking the IRS expert's testimony, the court emphasizes that RVI's cumulative loss ratio through 2006 was 28 percent, and in subsequent years it increased to 34 percent, which indicated that RVIA had taken on significant risk of loss.

(2) Risk Distribution

The risk distribution prong of the insurance test is not discussed extensively in the opinion, and was not the crux of the disagreement between the IRS and RVIA. Indeed, one of the IRS' experts acknowledged that RVIA achieved pooling, diversification, and distribution of risk.

Tax Court's risk distribution standard (paraphrased): The court concludes that meaningful risk distribution is sufficient, stating that "perfect independence of risks is not required."[12] Noting that all insurers face systemic risk—e.g., economic downturns, high interest rates—the court concludes these systemic risks do not negate risk distribution.

Outcome of Tax Court's analysis: The court concludes that risk distribution is satisfied as RVIA took on a "vast array" of risk

exposures and distributed risk on the RVI Policies temporally, geographically, and across asset classes.[13]

Support for Tax Court's conclusion: The court notes that during 2006, RVIA had issued 951 policies to 714 insureds covering 754,532 vehicles, 2,097 real estate properties and 1,387,281 commercial equipment assets. The RVI Policies were distributed across three major business segments (i.e., passenger vehicle, commercial equipment, real estate), and further distributed across asset types within each segment, across geographic locations (for real estate), and across lease duration ("temporal distribution").[14]

The court emphasizes that systemic risk, such as major recession, is mitigated to some extent by the temporal distribution of RVIA's risks over varied lease terms.

(3) Insurance in Its "Commonly Accepted" Sense

The commonly accepted notions of insurance prong of the insurance test is discussed more extensively than either the risk shifting or risk distribution prong.

Tax Court's "commonly accepted sense" standard (verbatim): The court sets forth factors to consider to include "(1) whether the insurer is organized, operated, and regulated as an insurance company by the States in which it does business; (2) whether the insurer is adequately capitalized; (3) whether the insurance policies are valid and binding; (4) whether the premiums are reasonable in relation to the risk of loss; and (5) whether premiums are duly paid and loss claims are duly satisfied" (citing *Harper Group v. Commissioner* and *Securitas Holdings*).[15]

Outcome of Tax Court's analysis: The court finds that the RVI Policies constitute insurance within the commonly accepted sense because RVIA was organized, operated and regulated as an insurance company and the RVI Policies are treated as insurance for nontax purposes.

Support for Tax Court's conclusion: The court emphasizes that RVIA and RVIG were organized, operated and regulated as insurance companies in their respective domiciles. RVIA and RVIG met the minimum capital requirements of their respective regulators, and were adequately capitalized. State regulation is highly significant to the determination of insurance in its commonly accepted sense.

The RVI Policies were valid and binding. Insureds filed claims, and RVIA paid claims. Premiums charged were negotiated at arm's length. The RVI Policies were insurance in form and contained "standard provisions typical of insurance policies."[16]

The court characterizes the IRS' argument as amounting to an argument that the RVI Policies do not qualify as insurance because they "differ in certain respects from insurance policies with which most people are familiar."[17] Whether a loss has occurred cannot be known until the associated lease ends, but the fact that loss determination and payment occurs at lease end "does not impugn [the RVI Policies'] status as 'insurance.'"[18]

Losses on the RVI Policies are caused by fortuitous events beyond the insured's control. The fact that there is a set date, i.e., the end of the lease term, for determining whether a loss has occurred doesn't change this. The characteristics and business needs of the underlying leasing transactions drive this timing. The court concludes that nonrefundable premiums do not change this result, as the lack of availability of a premium refund is designed to prevent an insured whose asset has very likely appreciated in value from opportunistically discontinuing coverage halfway through the term of the lease.

The RVI Policies are analogous to municipal bond insurance with respect to the timing of loss determinations, i.e., where bond interest due dates and maturity dates are known in advance, but this does not mean the loss-causing event occurs in a non-fortuitous way.

(4) Insurance Risk

Whether the RVI Policies cover insurance risk, as juxtaposed against investment risk, is at the heart of whether the RVI Policies constitute "insurance," and must be examined from the perspective of both the insurer and the insured. -

Tax Court's insurance risk standard (paraphrased): Regarding insurance risk, the crux of the court's analysis is that if a product has been treated as involving insurance risk by state insurance regulators and by an insurer's independent auditors, it can involve insurance risk even if it resembles an investment product in some respects.

Outcome of Tax Court's analysis: From RVIA's perspective, it was exposed to risk for significant underwriting losses; RVIA's

possible loss under an RVI Policy could vary from zero to the full insured value. Pricing risk does come into play, as premiums are rarely more than 4 percent of the insured value—but this is "the same pricing risk assumed by insurance companies generally."[19] From the insured's perspective, the loss insured against is not an investment loss, but a business-related loss as the insured is in the business of leasing or financing assets.

The court was unpersuaded by the IRS' argument that the RVI Policies are akin to put options on stock and, thus, are investment related rather than insurance related.

Support for Tax Court's conclusion: RVIA is an insurance company licensed to conduct the business of insurance; it pays state premium taxes, and meets minimum solvency requirements.

For more than 80 years, states have regulated products that provide coverage against the decline in market values of particular assets as "insurance." Certain states, e.g., New York and Connecticut, have by statute defined residual value policies as "insurance" for almost 30 years.

RVIA's insurance regulators and independent auditors concluded that the RVI Policies involve insurance risk. State insurance regulators have "uniformly" concluded that the RVI Policies involve insurance risk.[20] RVIA's independent auditors, along with the Connecticut Insurance Department, approved RVIA's statutory financial statements, which treat the RVI Policies as transferring sufficient insurance risk to be treated as "insurance" under SSAP 62R.

The IRS expert's argument that insurance must entail "pure risk," i.e., a binary situation must exist whereby the only possible outcomes are "loss" or "no loss," lacks practical and theoretical support. Certain other coverages, such as mortgage guaranty insurance and municipal bond insurance, do not involve such binary outcomes but still are (and have been, historically) respected as involving "insurance" risk. In asserting its "pure risk" theory, the IRS is "confusing the events that may trigger a payment obligation with the events that actually cause the loss."[21] So, for example, a homeowner's default on a mortgage payment may or may not result in a loss, depending on whether the outstanding mortgage amount is greater than or less than the value of the mortgaged property.

The court was unpersuaded by the IRS' argument that the RVI Policies entail mere investment risk and are akin to put options on stock. First, the court noted that "the insureds are not investors and the policies are not derivative products."[22] Indeed, the IRS agrees that the RVI Policies are not and cannot be taxable as derivative products; the policies were priced, sold and regulated as insurance products. Second, the court describes the assets that are covered by the RVI Policies as "ordinary business assets in the nature of inventory or equipment."[23] The insureds don't acquire the assets to sell them and generate gain; indeed, the lessors' business model takes into account the fact that the value of the assets likely will decrease over the duration of the lease. Third, put options are "typically settled for cash rather than by actual transfer of the underlying shares."[24]

RVI'S CONTRIBUTIONS TO THE TAX DEFINITION OF "INSURANCE"

The decision in *RVI* provides substantial taxpayer-friendly language that can be relied upon in discussions with the IRS regarding non-"plain vanilla" insurance products, both in the life and nonlife context. The opinion doesn't cover new ground in the risk shifting and risk distribution context, but significantly expands upon previous courts' discussions of "insurance risk" and "commonly accepted" notions of insurance.

The main issue in the case was how to differentiate "insurance risk" from "investment risk." The IRS has a history of challenging nontraditional forms of insurance coverage, especially when the product appears to be non-casualty-related, e.g., when there is a contract end date on which it is determined whether a loss has occurred and the extent of such loss, rather than a sudden casualty-type loss. *RVI* strongly rejects the IRS' attempt to pigeonhole an unconventional, risk-based product, such as residual value insurance, into a "non-insurance" category and signals the Tax Court's willingness to analyze the insurance features of each product individually.[25]

The Tax Court relies heavily on the state regulatory treatment of the RVI Policies—especially since that treatment is longstanding. Form matters. One might even say the decision in *RVI* makes treatment as "insurance" versus an investment or financial product elective. For example, opportunities may exist to choose insurance characterization by issuing products in an insurance company that is regulated by the state, using insurance contractual terms rather than derivatives contractual terms, and characterizing a particular product as insurance under statutory accounting rules. The Tax Court's reliance on state regulatory treatment and statutory accounting may provide support for such reliance in other contexts and for other types of products or product innovations.

In rejecting the IRS' "pure risk" theory, the Tax Court implicitly acknowledged there can be gradations of insurance coverage and varying levels of losses and self-insurance. The court's refusal to endorse a binary model of risk continues the facts-and-circumstances-based flavor of the "insurance" inquiry for federal income tax purposes—which provides opportunities as well as introduces potential pitfalls. In light of the Tax Court's sound rejection of this theory in *RVI*, it would be a bit surprising if the IRS were to re-assert the theory in other cases.

In rejecting the IRS' analogy to put options on stock, the Tax Court introduced a newly relevant concept: insurance protects against losses on regular business assets. As pointed out in the opinion, the lessors that purchased the RVI Policies did not expect the covered assets to appreciate; they expected the assets to decline in value and purchased the RVI Policies to protect themselves from large business losses. Lack of potential upside in an arrangement may tend to support insurance characterization over investment characterization.

Overall, *RVI* refines the contours of the insurance risk and "commonly accepted" prongs of the "insurance" test for federal income tax purposes. It is unlikely, however, that a bright-line test defining "insurance" will emerge—and perhaps that works out best in the long run both for taxpayers and the IRS: Taxpayers can continue product innovation and take positions regarding insurance versus non-insurance status, and the IRS can challenge arrangements it views as abusive. ■

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Sheryl Flum is a managing director at KPMG LLP's Washington National Tax practice and may be reached at *sflum@kpmg.com.*

Jean Baxley is a director at KPMG LLP's Washington National Tax practice and may be reached at *jbaxley@kpmg.com*

END NOTES

[1] The use of the term "insurance" does not automatically mean the product qualifies as insurance for federal income tax purposes.

[2] *R.V.I. Guaranty Co. Ltd. v. Commissioner,* 145 T.C. No. 9 (Sept. 21, 2015).

[3] Having tax treatment as insurance conform to state regulatory treatment as insurance would be a simple, bright-line rule, but could at times be both under- and over-inclusive.

[4] Accordingly the tax litigation was conducted in RVIG's name.

[5] RVIG also reinsured a small amount of business written by third-party carriers; this third-party reinsurance represented less than one percent of RVIG's business in 2006.

[6] Some of the RVI Policies used a pooling methodology under which multiple assets with lease termination dates within a specified period were covered under a single policy, and the determination of a loss on the policy was made on an aggregate basis, i.e., a loss on a pooled policy occurred if the aggregate value of the pooled assets at lease-end was less than the aggregate insured value of the pooled assets.

[7] For GAAP purposes, RVIA treated the RVI Policies as derivatives under FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities* (June 1998) and EITF No. 01-12, *The Impact of the Requirements of FASB Statement No. 133 on Residual Value Guarantees in Connection with a Lease* (2002) when the residual value was determined based on the higher of the actual sales price of the property or the value set forth in a specified guidebook (e.g., the "Blue Book" value for automobiles).

[8] This challenge was not unexpected, as the IRS Office of Chief Counsel had issued TAM 201149021 (Dec. 9, 2011), taking the position that residual value insurance contracts were not "insurance" for federal income tax purposes. *See* Baxley, Juran, Chen, Pichette, *Residual Value Contracts Fall Outside the (Fuzzy) Line*, 21 BNA DTR 1, J-1 (Feb. 2, 2012).

[9] Slip Op. 27.

[10] Slip Op. 28.

[11] Slip Op. 28.

[12] Slip Op. 35.

[13] Slip Op. 32.

[14] Slip Op. 35.

[15] Slip Op. 36–37.

[16] Slip Op. 38.

[17] Slip Op. 38.

[18] Slip Op. 39.

[19] Slip Op. 45.

[20] Slip Op. 48.

[21] Slip Op. 56.

[22] Slip Op. 57.

[23] Slip Op. 57.

[24] Slip Op. 58.

[25] Note that the Tax Court declined to express a view regarding coverage for loss of earnings attributable to foreign currency fluctuations, which was found to not qualify as "insurance" in CCA 201511021 (March 13, 2015).