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What is "Insurance" for Tax Purposes?

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What is "insurance" for income tax purposes? In the absence of a generally applicable definition in the Internal Revenue Code (IRC) and Treasury Regulations, taxpayers, the Internal Revenue Service, and the courts have struggled to define the term on a case-by-case basis.

The tax stakes involved are significant. Property and casualty "insurance" premiums incurred in the course of a trade or business or other activity engaged in for profit are generally deductible currently, under the same rules as are applicable to other business and investment expenses,[1] while the cost of other forms of risk management may have to be capitalized. At the same time, "insurance companies" benefit from special rules in the computation of their taxable income and expenses.[2]

The Tax Court's recent decision in *R.V.I. Guaranty Co. v. Commissioner*[3] addresses whether a company engaged primarily in the sale of "residual value insurance" with respect to property such as automobiles, commercial real estate, and commercial equipment may compute its income under favorable IRC provisions relating to "insurance companies."

Facts

The petitioners in *R.V.I. Guaranty* included R.V.I. Guaranty Co., Ltd. (RVIG), a company incorporated and regulated in Bermuda as an insurance company, and R.V.I. America Insurance Company (RVIA), which was incorporated in 1994 as a property and casualty insurance company and domiciled in Connecticut. RVIG elected under IRC section 953(d) to be treated as a domestic corporation for Federal income tax purposes, and a consolidated Federal tax return was filed by RVIG and its subsidiaries (collectively RVI) for 2006, the tax year at issue.

During 2006 RVIA was engaged exclusively in the business of issuing residual value insurance policies. These policies were issued to lessors and financing companies that leased and financed automobiles, commercial real estate, aircraft and rail cars, and other equipment. The policies insured against the risk that the value of leased property would be significantly below the expected value of the property at the termination of the lease.

Typically, the premium for the policy was paid in a lump sum at the time the policy was issued; the amount of the insured value under the policy was slightly less than the expected residual value of the underlying property at the time of termination of the lease; and the insurer was obligated to pay the excess, if any, of the insured value over the actual value of the leased property at the end of the lease. Almost all of the risk under these policies was reinsured by RVIA with RVIG.

Following an audit, the IRS concluded that the policies issued by RVI "insured against market decline" and did not constitute insurance contracts for tax purposes, that RVI was accordingly not an "insurance company" as defined in the IRC, and that RVI's taxable income was not properly computed under the favorable provisions applicable to such companies, but, rather, under the provisions applicable to most taxpayers. The IRS determined a tax deficiency of $55 million for 2006, and RVI filed with the Tax Court for redetermination of that deficiency.

Discussion

Under applicable statutory and regulatory provisions, RVI would not be an "insurance company" for 2006 unless more than half of its business for that year was "the issuing of insurance or annuity contracts" (or the reinsuring of risks underwritten by other "insurance companies");[4] and, under applicable case law, the policies offered by RVIA could constitute "insurance" only if they involved "risk shifting" and "risk distribution." Both parties offered expert testimony on these points.

The court observed that insurance is intended to be a means "by which the insured obtains protection from financial loss by paying the insurer a premium." Consistent with that observation, the opinion stated that the risk shifting requirement for insurance would be met if the residual value policies provided financial protection to the insureds against

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significant economic risks, and if RVI was sufficiently well capitalized to satisfy claims under those policies.

The parties' experts agreed that the policies did shift some risk of loss, and there was no apparent controversy as to whether RVI was adequately capitalized. The government argued that the policies did not transfer enough risk of loss, however, because losses requiring payment under the policies were relatively unlikely to occur. The court dismissed that argument on conceptual and practical grounds.

First, the court noted that "catastrophic" insurance coverage against losses resulting from earthquakes, major hurricanes and the like, which is well accepted as a form of insurance, is written to cover low frequency risks, such that an insurer might have no claims under such policies in some years. The government's expert acknowledged that even where the likelihood of a loss occurring was low, that circumstance was not viewed by insurance regulators as indicating that policies providing for coverage against such a loss was not insurance.

The court also noted that, although in some years RVI paid relatively little under its policies in force, its ratio of paid losses to earned premiums (the "loss ratio") was much higher in other years, and, indeed, was as high as 98% during the financial crisis year of 2008. Taking that into account, the court concluded that it was clear that the level of risk transferred was sufficient to meet the risk shifting requirement for insurance.

The other key requirement under case law for an arrangement to constitute insurance for tax purposes is "risk distribution," which is described in the opinion as insuring many independent risks in a manner that serves to distribute risk, thereby reducing the possibility that any single claim will exceed the amounts collected by the insurer and held in reserve for the payment of claims.

The record before the court indicated that RVI had more than 900 policies in force in 2006, covering more than 700 different insured parties, and relating to property that included approximately 750,000 passenger vehicles, 2,000 real estate properties, and 1,400,000 pieces of commercial equipment. The assets were varied in nature, the covered real estate was located in seven geographic regions, and the relevant lease terms ranged from one year to 28 years.

Notwithstanding the apparent diversification of covered risks, the government argued that the residual value policies did not distribute risk to a sufficient degree because certain foreseeable events, such as a major recession, would likely cause simultaneous reduction in numerous insured property values. The court noted, however, that other types of insurance that are clearly insurance for tax purposes, such as mortgage guaranty insurance, municipal bond insurance, and financial guaranty insurance, are similarly susceptible to claims associated with macroeconomic events such as a recession or instability in the credit markets.

The court also noted that prior case law had established that the "risk distribution" requirement for insurance would be met so long as there is "meaningful" risk distribution, even if some of the risks are highly correlated. The court concluded that the RVI policies effected a degree of risk distribution that was sufficient to be classified as insurance for tax purposes.

The opinion also noted that other factors that have been considered by the courts in determining whether an arrangement constitutes insurance include: whether the insurer is organized, operated, and regulated as an insurance company by the states in which it does business; whether it is adequately capitalized; whether the premiums are reasonable in relation to the risk of loss; and whether, in the normal course of the insurer's operations, premiums are collected and claims are paid. The manner of treatment for state regulatory purposes is especially significant because of the delegation of exclusive authority by Congress to the states, under provisions of the McCarran-Ferguson Act cited in the opinion, to regulate insurance.

All these factors were found by the court to support RVI's position. RVIG and RVIA were each registered and regulated as insurance companies in their home states, and RVIA was also licensed in various other states in which it issued policies. Each company met the capital and surplus requirements imposed by its regulators; the policies issued by RVIA were negotiated at arm's length between RVIA and its various insureds, unrelated by ownership to RVI; and the policies had provisions typical of insurance, including the requirement of an "insurable interest."

The government argued, nonetheless, that the residual value policies were not insurance because they did not pay upon a fortuitous event, such as a collision, but rather upon an event known to the parties in advance, namely, the end of the term of the related lease. The court found this to be irrelevant, taking into account that there remained a high degree of uncertainty as to whether and when events of a localized or macroeconomic nature would occur before the relevant date that would give rise to a loss covered by insurance.

The court similarly found that that the circumstance that many of the RVI policies provided for nonrefundable premiums, which the government alleged was atypical of insurance policies generally, was an outgrowth of the economics of the underlying transactions and did not suggest that the policies represented something other than insurance.

The government further argued that the policies were not insurance for tax purposes because the nature of the risk covered by the policies was not an insurance risk from the perspective of the insureds but rather an investment risk, namely, the risk that the property owned and leased by an insured might decline in value by a greater-than-expected amount. The government argued that the risks covered were analogous to the risk of a decline in the stock market with respect to which a stock investor might seek protection through the purchase of a put option (which would not be insurance for tax purposes).

The court found this argument unpersuasive. It noted that New York and

Connecticut had, by statute, defined residual value policies as insurance; that courts in other states had reached that same conclusion; that insurance regulators had uniformly found that residual value policies involve "insurance risk"; and that the accounting firms auditing RVI had not expressed any concerns in this regard. The argument was also undercut by the recognition by the IRC and federal case law of other types of insurance, such as mortgage guaranty insurance and municipal bond insurance, as insurance for tax purposes, since the losses covered by such insurance are similarly associated with declines in market value that may be caused by macroeconomic conditions.

The Tax Court concluded, ultimately, that the residual value insurance policies issued by RVI constituted insurance contracts for tax purposes, and therefore that RVI was an insurance company within the meaning of the IRC.

Observations

R.V.I. Guaranty indicates an interesting interplay between the delineation of what is and is not insurance for Federal tax purposes, and the manner in which insurance is defined and regulated by the states. The lack of a general definition of "insurance" for tax purposes in the IRC and the Treasury Regulations has caused courts in tax matters to give substantial deference to determinations under state law and by state regulators as to what is or is not insurance. The states' determinations thereby affect the resolution of this issue as a Federal tax matter, even though the states may not take into account the factors that underlie the need to distinguish between insurance and investment risks for Federal tax purposes, including necessary protection of the fisc.

The discussion in the case also indicates that the court found the petitioners' experts to be more credible than those of the government, and that may have influenced the result. Notwithstanding that caveat, the decision should be welcomed by companies leasing and financing property with respect to which residual value insurance has already been obtained or might be beneficial, as well as by the insurers providing this product.

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1 See, e.g., IRC § 461 and Treas. Reg. §§ 1.162-1(a), 1.461-4(g)(5).

2 See, e.g., IRC §§ 831, 832. The focus of this article is on property and casualty insurance, rather than life insurance, which is subject to different tax rules.

3 145 T.C. No. 9 (September 21, 2015).

4 IRC § 816(a).