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When Is a Business Risk an Insurance Risk?

By Fred Turner

This article explores the position taken by the IRS in many captive insurance company tax cases that a business/investment risk is not an insurance risk. Generally, a captive is an insurance company owned by the same individuals or entities that also own the insureds of the captive. Captives properly structured with the elements of an insurance company under federal income tax law allow deduction of premiums paid. However, the insurance policies issued by the captive must cover insurance risk. In the insurance world, the existence of insurance risk is determined by insurance regulators, auditors, and other insurance professionals. Typically, when the IRS determines that premiums are not deductible because the policies at issue cover risks that are not insurance risks, the state insurance regulator governing the captive has already found the policies to contain insurance risk, the auditors have not identified an absence of insurance risk, nor have any of the other insurance professionals involved in managing, governing, and running the captive. Nevertheless, the IRS in these cases determines such policies cover business or investment risk instead of insurance risk and, in so doing, denies the deductibility of the premiums.

This article first addresses what insurance risk is generally, then covers the IRS's position on insurance versus business risk by exploring various tax court cases or other authoritative sources in which the IRS has taken a position.

What Is Insurance Risk Generally?

In the absence of Congress defining "insurance," the U.S. Supreme Court in *Helvering v. LeGierse,* 61 S. Ct. 646 (1941), assumed that Congress used the word "insurance" "in its commonly accepted sense." Additionally, insurance risk must contemplate the fortuitous occurrence of a stated contingency or peril. *Commissioner v. Treganowan*, 183 F.2d 288, 290–91 (2d Cir. 1950). Insurable risk begins with insurable interest and must involve the insurance risk of the insured that is transferred to the insurance company. *AMERCO v. Commissioner*, 979 F.2d 162 (1992). Whether any transaction will be viewed as insurance for tax purposes will depend on whether there has been a transfer of economic loss from the insured to the insurer. *Allied Fidelity Corp. v. Commissioner*, 572 F.2d 1190, 1193 (7th Cir. 1978). In *Allied Fidelity*, the taxpayer was in the business of writing bail bonds. The court held that any surety is "regarded as contracting principally to assume the Government's duty of supervising the defendant, rather than to compensate it for an economic loss," thus there was no insurance risk.

Moreover, a substantial factor in determining the existence of insurance risk is how state insurance regulators treat the transaction. See *AMERCO,* 979 F.2d at 162; I.R.S. Priv. Ltr. Rul. 200845043 (November 7, 2008). Logically, this includes coverages presently available from admitted surplus lines and specialty carriers worldwide, as well as coverages previously made available but from which the commercial market has withdrawn. The point here is that, if regulators or the commercial markets have treated a risk as insurance risk, then normally a captive should be able to cover that risk as well.

Generally speaking, an insurance policy's insuring clause, definitions, and exclusions detail the universe of what risks that policy covers. For example, the insuring clause of a commercial general liability policy (CGL) typically covers claims arising from bodily injury, property damage, advertising injury, and personal injury. Through exclusions, conditions, and other provisions, however, a CGL carrier removes from the insuring clause coverage for certain risks.

Standard Insurance Service Office form CGL policies are designed to protect insureds from losses arising out of their insured businesses, yet they contain what often are referred to as "business risk exclusions." These business risk exclusions preclude coverage for loss or damage associated with the product or the professional or commercial services of the insured. Despite their exclusion under CGL lines, business risks are insurance risks often covered or previously covered by other commercial lines, such as errors and omissions, professional liability, surety lines, performance bonds, and so on. It is noteworthy that, since the insurance liability crisis of the 1980s, commercial carriers have expanded and refined the application of business risks exclusions in addition to narrowing insuring clauses and definitions. For example, the typical 1984 CGL policy covered most unfair competition claims. That coverage has since been removed, likely because of the severity of trade-secret claims. Other business risks also excluded by CGL policies include risks relating to repair or replacement of the insured's faulty work or products, or defects in the insured's work or product itself. There are literally hundreds of examples of this in insurance coverage law. One example is a case that held that CGL policies do not cover workmanship of the contractor or builder, noting that the insureds must instead purchase other insurance policies that cover these insurance risks, such as performance bonds or builders' risk policies. *Nationwide Prop. & Cas. v. Comer,* 559 F. Supp. 2d 685 (S.D. W. Va. 2008).

As suggested by the *Nationwide* decision, because there are business risk exclusions in CGL policies, other policies step up to the coverage plate and provide coverage for risks not covered under standard form CGL lines, including forms of surety or warranty coverage, performance bonds, construction wrap-up policies, errors and omissions, or contractual liability policies. In fact, surety and/or performance bonds have been determined by the IRS to be insurance contracts. For example, Technical Advice Memoranda 8406001 provides:

> The surety bonds written by the taxpayer involve an agreement on the part of the taxpayer, as the surety, to protect the insured (the obligee) against an economic loss arising from a defined contingency (the principal's default). For example, in the case of its license and permit bonds, the taxpayer agrees to protect the obligee, typically a governmental body, against monetary damages which it might suffer through claims brought against it arising out of specific acts of the principal, for which the principal itself has failed to compensate the obligee. Similarly, in the case of its performance bonds, the taxpayer, in effect, agrees to protect the obligee (owner of the premises) against economic loss arising out of the contractor's default under the contract. The surety bears the economic risk of having to have the contract completed by another contractor or to provide sufficient funds to pay the cost of completion, up to the penalty of the bond. Unlike the bail bond writer in *Allied Fidelity*, the taxpayer in the instant case does not assume a present duty of performance; rather it stands ready to assume the financial burden of any covered loss. The risk of future economic loss arising out of the principal's default has been shifted from the obligee to the taxpayer under its surety contract.

In addition, *In re Whether Surety Bonds Are Insurance Contracts for Subchapter L Purposes,* I.R.S. Gen. Couns. Mem. 39,154 (1984) determined: "We conclude surety bonds written by the taxpayer constitute insurance contracts for purposes of subchapter L of the Code…The risk has been shifted from the obligee to the taxpayer. Each of the surety bonds written by the taxpayer involves an agreement on the part of the taxpayer to protect the obligee against direct or indirect economic loss arising out of the principal's default."

Below is a chronological recitation of other relevant court decisions, advisories, and guidance that illustrate the IRS's view on what is—or is not—insurance risk.

The Development of the IRS's Position on Business Risk

***Helvering v. LeGierse*, 61 S. Ct. 646 (1941).** In *LeGierse*, the court looked at a life-insurance policy and an annuity contract sold together as one transaction. Each policy was issued separately on different, but standard, forms. The life insurance provided a death benefit of $25,000, with a one-time premium payment of around $22,000, and the annuity provided for $590 in annual income for life, with a one-time premium payment of about $4,000. The insurance company received more premiums than the death benefit and, thus, no insurance risk from the death of Ms. LeGierse. The only risk assumed by the carrier was whether the investment income it earned on the premiums would exceed the annuity payment and, thus, only an investment risk similar to that of a bank that takes a deposit, pays passbook interest, and hopes to earn more on loans. As a result, the IRS argued—and the court held—that the proceeds of the life insurance policy were to be included in the gross estate of the decedent because there was no insurance risk.

An overbroad application of the *LeGierse* decision has been used by the IRS time and again to stand for the proposition that investment or business risks of an insured can never be insurance risks. However, the IRS seems to be losing sight of what is a fortuitous loss as it struggles to limit insurance risk. As David S. Miller rather succinctly put it in *Distinguishing Risk: The Disparate Tax Treatment of Insurance and Financial Contracts in a Converging Marketplace*, 55 Tax Law 481 (2002), "the distinction made between an insurance contract that merely or predominately transfers insurance risk, and an investment or financial instrument, which predominately compensates for the use of capital or transfers market risk, is an economically viable distinction that remains important." Thus, the point is not whether the *LeGierse* court was correct, which no one disputes, but that *LeGierse* has little to no application outside of the particular and peculiar facts presented by that case.

Revenue Ruling 68-27 (1968). In this Revenue Ruling, a company issued medical services contracts for the injured and the sick, as well as preventive care to various groups and individuals, and provided direct medical services to those persons through their medical clinic staffed with salaried physicians, nurses, and technicians. The company wanted to be taxed as an insurance company. When the clinic was unable to perform the medical services contracted for, the clinic was unequipped to provide the patient the specific treatment, or because the patient required hospitalization—the company paid through its purchase of a commercial policy.

The IRS determined that the company was not an insurance company because it was the business of the company to sell its services on a fixed basis, which was almost entirely without taking on a peril or hazard via the issuance of insurance contracts. With respect to the sick or disabled phase of the contract, although an element of risk existed, it was not predominant. The risks of the company were "normal business risks" of such an organization furnishing medical services on a fixed-price basis, rather than an insurance risk.

IRS General Counsel Memoranda 39,146 (1984). In this memorandum, general counsel evaluated a corporation set up to assume a portion of warranty exposures of builders. The policies issued covered exposures for inherent defects that result in claims occurring as the direct result of loads to buildings generated by wind, snow, sleet, ice, or an combination thereof that were not covered by other collectible insurance of the builders or homeowners. The corporation was a separate entity from the builder, but it assumed, in part, the risk of the builder's warranty. General counsel, relying on state court cases involving the question of whether a certificate of authority was required for warranties given by manufacturers, concluded that this risk was not an insurance risk:

> Whether one labels the contract in question . . . as a guarantee contract, or a warranty contract, or a service contract, fundamentally what is present is a business arrangement to repair or replace property due to an inherent defect in that property. There is no outside peril, no personal injury, no other property damage, and no consequential damage involved. The risk that is being transferred is the inherent defect in the property (and the discovery thereof) that is identical to the business risk present in the issuing of a warranty.

Although having the attributes of insurance risk, manufacturers of embedded warranties are not required to obtain a certificate of authority as an insurance company by regulators because their financial statement stands behind the risk. Chief counsel cites *State ex rel. Duffy v. Western Auto Supply Co.,* 16 N.E.2d 163 (Ohio Sup. Ct. 1938), which held that manufacturer-of-goods warranties do not require a certificate of authority, but for warranties that tires are fit against all road hazards, a certificate of authority is required. An extended warranty issued by a service contract administrator is backed by a contractual liability policy from a commercial carrier with reserves, and embedded warranties are backed by the financial statement of the manufacturer to ensure that the public is protected. The point is that, even when a state regulator does not require a certificate of authority for public policy reasons, embedded warranties are still covering insurable risk.

Performance bonds, which the IRS recognizes as covering insurance risk, cover contractual obligations including embedded warranties, so would the result have been different if what was at issue was entitled "performance bond" that covered the embedded warranties? Here, the warranty only provided coverage if a loss occurred as a result of wind, snow, sleet, ice, or a combination thereof, which sounds like a peril or fortuitous event similar to those in some of the cases upon which chief counsel relied, and thus is similar to those cases in which a certificate of authority requirement was triggered. Yet, chief counsel determined that these were not insurance risks because the warranty only protected against defects in the manufacturing process, which the builder controlled. Thus, there was no "outside peril" or fortuitous loss. Control by an insured over a process, or even anticipating a loss to be likely, is still a fortuitous risk when that insured does not know the exact timing, place, or cost of future covered losses. Even a controlled process can still present risk.

Although commonly accepted notions of insurance do not include coverage for a loss already in progress or for planned or intended losses, an insured's control that may cause a contingency or peril to manifest should not negate insurance risk. For example, in the context of auto liability, an auto liability carrier could hardly deny coverage for an auto accident just because its insured was controlling the car while driving. In fact, control of the vehicle and who was the at-fault driver can ultimately determine which carrier pays the loss. The IRS's use of "control" to define something as an uncovered business risk to negate insurance risk is a concept inconsistent with insurance in its "commonly accepted sense."

IRS Chief Counsel Advice 200628018 (July 14, 2006). The question here was whether a limited express warranty included in the purchase price of the consumer goods was an insurance risk. No separate price was paid for the warranty; it was a package deal. The policy covered express limited warranties claims to repair or replace defective consumer goods occurring during a specified period of time. The CCA determined no insurance risk—only a business risk—because the limited express warranty was an inseparable part of the goods produced and sold; fortuity was lacking because the insured had control over the production of the goods sold, and the consumer had not paid separately for the warranty.

In the insurance world, many commercial insurance policies cover claims stemming from risk or loss within the insured's control and covered by an insured's contractual obligations, including product recall, performance bonds, professional liability, and auto liability to name a few. In the modern world economy, consumer products often incorporate components made by unrelated and uncontrolled manufacturers from all over the world. Mistakes are made, and that is why businesses buy insurance. Here, the product manufacturer and consumers might even expect that defects will happen in the ordinary course of business (which is why it offered embedded warranties in the first place), and although the manufacturer might do its best to control the manufacturing process to eliminate defects, defects may still manifest. An attorney drafting a trust has a legal and contractual obligation not to violate the rule against perpetuities and controls the drafting process, but clearly can insure this risk with a professional liability policy. Professional liability is insurance in the commonly accepted sense. Would the IRS deny deduction of those premiums or claim that the professional liability carrier is not an insurance company for federal income tax purposes?

IRS Chief Counsel Advice 200629028 (July 21, 2006). When considering captive coverage for decommissioning costs for nuclear power plants, this CCA determined that such costs did not present insurance risk and only a business/investment risk existed. It was inevitable that the nuclear power plants would have to be decommissioned in the future—there were "estimates" as to the decommission dates projected costs for decommissioning. The CCA determined that, because decommission-related risks were inevitable, they were business risks akin to the investment risks presented in Revenue Ruling 89-96. In that ruling, the insured suffered a known liability loss that was expected to exceed \$130×, but only had \$30× of existing insurance coverage. The insured bought an additional \$100× of coverage for \$50× of premium from a new insurance carrier. The new insurance carrier treated the \$50× of premiums as fully earned and took an appropriate discount on the unpaid loss of \$100× as a deduction against the \$50× premium income and other underwriting income, gaining a tax benefit. Adding the \$50× premium income, the tax benefit, and investment income together, chief counsel determined that the total would reasonably exceed the \$100× policy limit. From this, chief counsel determined that the new carrier had no insurance risk, only an investment risk akin to the facts in *LeGierse.*

The chief counsel furthered opined that, when a nuclear power plant is placed in operation, it is inevitable that the licensee will incur the cost of decommissioning the plant when operation ceases. Given that it was inevitable, chief counsel determined that there was no hazard or fortuity and, thus, no insurance risk. Chief counsel ignored the language in *Commissioner v. Treganowan*, 183 F.2d 288, 290–91:

> From an insurance standpoint there is no risk unless there is uncertainty, or, to use a better term, fortuitousness. It may be uncertain whether the risk will materialize in any particular case. Even death may be considered fortuitous because the time of its occurrence is beyond control.

The recent tragedy in Japan demonstrates how factors such as weather and political forces can affect the timing and cost of decommission. As Erin L. Webb explains in *Nuclear Law Committee Newsletter of the American Bar Association Section of Environment, Energy, and Resources,* Vol. 7, No. 1 (Sept. 2014), nuclear power plants are required by law to carry high limits of property insurance, which often contain endorsement coverage for cost overruns in decommission costs if the plant is damaged and decommissioned early. Chief counsel's determination is contrary to case law and inconsistent with insurance in its "commonly accepted sense."

IRS Chief Counsel Advice 201511021 (March 31, 2015). This CCA determined that the risk of currency fluctuation is not an insurance risk. The insureds conducted business throughout the world such that "sales and purchases in currencies other than the U.S. dollar exposed [the Group] to fluctuations in foreign currencies relative to the U.S. dollar and may adversely affect [the Group's] results of operations and financial condition." Citing *LeGierse*, chief counsel determined that there was no insurance risk, noting that "not all contracts that transfer risk are insurance policies even when the primary purpose of the contract is to transfer risk." Chief counsel equated diminution in profits to the IRS's concept of investment/business risk despite the commercial availability of exchange rate, business interruption, loss rents on real estate investments, or credit insurance that covers loss income and thus affects profits. Fortuitous loss causing diminished value is commercially insurable in many contexts.

***R.V.I. Guaranty Co. v. Commissioner*, 145 T.C. No. 9 (Sept. 21, 2015).** Although it did not involve a captive, this decision is extremely important in the captive world as persuasive authority on the issue of what defines business versus insurance risk. In this case, the insurer issued policies to cover residual value risks in leases. The insured assets were vehicles, real estate, and equipment. The insurance policies provided coverage against the risk that the insured assets would decline more rapidly in value than expected so that the asset value at lease termination would be much less than originally contemplated at the time of leasing. The way these contracts worked is that, if the asset's actual value was less at the end of the lease than the insured value, R.V.I. Guaranty Co. would pay the difference under the policy. Thus, the loss compensated under the policy was the difference between actual value and assumed value at the end of the lease. The Service concluded that residual value insurance (RVI) policies did not insure insurance risks. In the Service's view, the lessors were purchasing protection against market decline risk, an investment risk, not an insurance risk.

The court disagreed, however, noting the commercial availability of such insurance and that other professionals who would have an obligation to say it was not insurance, such as auditors, actuaries, and regulators, treated it as insurance. The events that could cause losses under the RVI policies varied, but included recessions, high unemployment, interest rates increases, technological obsolescence, loss of a major tenant, and urban blight. The court accepted as credible testimony that financial risks that cover speculative risks are commonly insured, such as trade credit insurance, mortgage guaranty insurance, and municipal bond insurance. The IRS's position in *RVI* was that the RVI policies did not transfer "enough" risk of loss because losses were relatively unlikely to occur. As the court noted, however, catastrophic insurance coverage for low-frequency, high-severity risks such as earthquake insurance, where the carrier may go years or decades without paying a claim, does not mean it is not insurance.

Captives Serve a Vital Economic and Risk Management Role

As the U.S. economy expands into new types of business arrangements and further integrates into the world economy, insurance products will also change. Businesses faced with increasing regulation and legal liability also are presented with more risks than in the past—risks that are not covered by existing commercial products. The commercial markets do not—and will not—always provide capacity for all these risks. Captives provide capacity in part for risks uncovered by the commercial market. Unfortunately, the IRS historically has taken an adversarial approach to captives despite the intent of Congress to foster captives to expand capacity in the overall insurance market. Captives serve a needed risk-management function for small, medium, and large companies, especially for risks not covered by the commercial markets, either at all or because they are unaffordable. The IRS's "business risk" argument is a continuation of the IRS's attempts to come up with creative new arguments to counter Congressional intent to foster captives to expand capacity in the insurance markets—a proposition that the courts have largely rejected.

Fred Turner is the founder of Active Captive Management, a leading innovator of the single parent captive structure. He currently serves as the vice chairman of the ABA Business Law Section's Captive Insurance Committee and director of the Utah Captive Insurance Association.

ADDITIONAL RESOURCES

For other materials related to this topic, please refer to the following.

In The Know

Captive Insurance Best Practices and the Defense of IRS Attacks (Access PDF, Audio, and Video here)

The group of experts will discuss best practices in establishing captives that qualify as insurance companies for Federal income tax purposes. The panel will also address how to best withstand the IRS recent attacks on captives, as well as discuss recently proposed legislation and pending cases.

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Webinar

Small Captive Insurance Company IRS Compliance and Audit Defense (Access PDF and Video here)

Panelists will address tax issues for small captive owners both before and after IRS tax controversy arises. After addressing best practices from a tax perspective, panelists will address issues that arise during the course of a tax controversy for captive owners, such as audit defense, appeals settlement and litigation.

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Current Tax Issues with Captive Insurance Companies

By Beckett G. Cantley and F. Hale Stewart

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