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Insurance: IRS concludes some foreign currency agreements are not insurance

The IRS publicly released a Chief Counsel Advice memorandum (CCA)* that determines an arrangement involving foreign currency fluctuations between an affiliated group and a related captive insurer does not constitute insurance for federal income tax purposes.

The IRS noted that, while the arrangement met some criteria within the definition of "insurance," the taxpayer did not demonstrate that this agreement constitutes insurance in its commonly accepted sense.

Read **CCA 201802014** [PDF 82 KB] (release date of January 12, 2018, and dated October 6, 2017)

*Chief Counsel Advice materials are written advice or instructions prepared by the Office of Chief Counsel and issued to field or service center employees of the IRS or Office of Chief Counsel.
They are considered to be informal guidance and are not to be used or cited as precedent.

Background

The taxpayer is the parent of a group that designs, manufactures, and markets professional, medical, industrial, and commercial products and services. The group includes a pure captive insurance company (Captive) that may not insure any risks other than those of its parent and affiliated companies. Captive insures various types of risk for the U.S. members of the group, including (but not limited to) automobile liability, product liability, general liability, workers' compensation, and credit guarantee insurance.

As the group conducts business globally, it is exposed to fluctuations in foreign currencies relative to the U.S. dollar that may adversely affect the group's operations and financial condition. To limit these risks, in Month A of Year 2, the taxpayer entered

into two categories of contracts with Captive on behalf of the group's U.S. members (Participants) to cover the exchange rate risk between the U.S. dollar and certain foreign currencies. These contracts covered policy periods of one year. In addition, monthly endorsements attached to the contracts extended them so that, in effect, each Participant had 12 separate contracts—one becoming effective each month and one expiring each month. The contracts were structured in this manner so as to provide protection against any strengthening or weakening trends in the U.S. dollar.

Contract 1 was intended to address currency risks related to receipts from selling products to foreign customers. Specifically, Captive agreed to indemnify Participants for the loss of earnings due to a decrease in the value of specified foreign currencies relative to the U.S. dollar. The amount of the indemnification was based on sales revenue received and generally limited to the amount of Participants' export sales for the prior year.

Contract 2 aimed to mitigate Participants' currency risks with respect to amounts owed to related foreign entities in their respective currencies. Losses under Contract 2 were generally limited to the amount of each Participant's outstanding loans at the contract's effective date.

The format and language of the contracts were consistent with traditional insurance policies. The contracts were also similar to traditional insurance policies in that they provided for the payment of premiums (generally two times the percentage of notional for a 12-month call option for the purchase of U.S. dollars against the specified foreign currency), claims administration, and the exclusion of any loss which was already covered under property or business interruption insurance.

IRS findings

Although the IRS previously concluded in CCA 201511021 (December 1, 2014) that similar contracts were not insurance, the IRS decided to reconsider its analysis in light of *R.V.I. Guaranty Co., v. Commissioner*, 145 T.C. 209 (2015).

The IRS noted that neither the Internal Revenue Code nor Treasury regulations define "insurance" for federal income tax purposes, but that courts—in cases such as *Rent-A-Center, Inc. v. Commissioner*, 142 T.C. 1 (2014) and *Sears, Roebuck & Co. v. Commissioner*, 96 T.C. 61 (1991) among others—have held that a captive insurance arrangement can constitute insurance for federal income tax purposes if it:

- Involves insurable risks
- Shifts risks of loss to the insurer
- Distributes risks among the policyholders
- Constitutes insurance in its commonly accepted sense

In the present CCA, the IRS concludes the following with respect to each required element:

Whether the contracts covered insurable risks

The IRS determined that the contracts in question did cover insurable risks because the adverse movement of foreign currency valuations presents the possibility of an economic loss. This loss could be considered a fortuitous event—a concept central to the notion of insurance risk. Despite the similarity these contracts bear to notional principal contracts, the IRS concluded that foreign currency risk can be an "insurance risk" for federal tax purposes.

Whether the risk is shifted to the insurer

The IRS concluded that, under each contract, the foreign currency risk appears to be shifted from each Participant to Captive. The IRS noted that, while the two contract types covered opposite risks, it appeared that no Participant was simultaneously covered by both types of contract with respect to the same foreign currency risk.

Whether the risk is distributed to the policyholders

The IRS stated that it did not have sufficient information to determine whether risk was properly distributed under the contracts, and particularly under Contract 2. The IRS noted that, in order to reach a conclusion, the IRS would need to further examine whether the arrangement involved a large enough pooling of unrelated risks to utilize the law of large numbers, citing *Avrahami v. Commissioner*, 149 T.C. No. 7 (2017) .

Whether the arrangement constitutes insurance in its commonly accepted sense

This was ultimately the deciding factor. The IRS determined that the arrangements failed this part of the four-part test. The IRS concluded that the taxpayer did not sufficiently demonstrate that the arrangement constituted insurance in its commonly accepted sense.

Though the contracts followed an insurance policy form, the IRS found that the coverage limit was ambiguous. In addition, no documentation had been provided showing that the premiums were set at arm's length or priced using insurance experience. In addition, the contracts' coverage did not appear to match Participants' risk of loss, and the results did not tie to the actual exposure of Participants to particular foreign currencies. The taxpayer and Captive acknowledged that the results under each contract were determined independently of the actual value of loss. In addition, Participants may both have currency losses over the life of a particular transaction (or group of covered transactions) and also not be eligible for a benefit under the contract. Finally, the sequential laddering of the contracts, each for the duration of a year, may result in a Participant having multiple recoveries. The possibility of multiple recoveries in itself suggests that the insurable interest may not be substantial in relation to the amount of insurance.

KPMG observation

The CCA is the first instance in which the IRS has determined that foreign currency movement is a fortuitous event that constitutes an insurance risk. Even though the ruling ultimately concludes that these particular contracts are not insurance in the commonly accepted sense, the discussion overall appears to indicate the possibility that a differently designed contract could qualify as insurance in the commonly accepted sense, provided that the taxpayer shows that the contract's coverage matches the insured's risk of loss.

In order to qualify as insurance, the policy must also establish that the risk of loss due to foreign currency fluctuations is sufficiently distributed among policyholders. This may be helpful to the industry in the design and marketing of new types of insurance.

For assistance with these matters, or more information, contact a KPMG tax professional:

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