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memorandum

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subject: Coverage of Foreign Currency Fluctuation by Captive

This memorandum addresses coverage of foreign currency fluctuation by a captive insurance company. This memorandum should not be used or cited as precedent.

LEGEND

Taxpayer =

Captive =
State =
Month A =
Year 2 =
Contract 1 =

Contract 2 =

Number A =
Number B =
Number C =
Number D =
Year 1 =

Date A =
Date B =
Year 3 =
Outside Actuary =
Actuarial Review =

Number E =
Number F =
Number G =
Number H =
Number I =
Number J =
Number K =
Number L =
Number M =
Number N =
Number O =
Number P =

ISSUE

Whether an arrangement between affiliated operating entities and a captive insurance affiliate concerning the fluctuation in the value of specified foreign currencies is insurance for federal income tax purposes.

CONCLUSION

While economic risk of loss arising from the fluctuation in the value of specified foreign currencies can be an insurable risk, certain terms of this arrangement do not comport with the commonly accepted sense of insurance. Thus, this arrangement does not constitute insurance for federal income tax purposes.

FACTS

Taxpayer is the parent of a group of business entities (hereinafter, Taxpayer and its subsidiaries are referred to as “Taxpayer Group”). Taxpayer Group designs, manufactures, and markets professional, medical, industrial, and commercial products and services.

Taxpayer Group includes a captive insurance company (“Captive”), which is regulated as a pure captive insurance company under State law. As a pure captive, Captive may not insure any risks other than those of its parent and affiliated companies. Captive provides coverage to U.S. members of Taxpayer Group for automobile liability, products liability, general liability, workers’ compensation, product warranty, credit guarantee

insurance, earthquake damage coverage, retiree medical cost coverage, and guaranteed renewable accident and health insurance.[1]
The U.S. members of Taxpayer Group for which Captive provides insurance are subsidiaries of Taxpayer. Captive is also a subsidiary of Taxpayer.

Taxpayer Group conducts business throughout the world. Sales and purchases in currencies other than the U.S. dollar expose Taxpayer Group to fluctuations in foreign currencies relative to the U.S. dollar and may adversely affect Taxpayer Group's operations and financial condition. Therefore, in Month A, Year 2, Taxpayer entered into two categories of contracts with Captive on behalf of U.S. members of Taxpayer Group ("Participants") to cover the risk arising from fluctuations in the rate of exchange between the U.S. dollar and specified foreign currencies. Contract 1 is intended to cover the Participants' currency risks with respect to receipts from the manufacturing and selling of products to foreign customers while Contract 2 is intended to cover the Participants' currency risks with respect to amounts owed to related foreign entities in their respective currencies. Taxpayer explained that a Participant is exposed to the effects of foreign currency valuations on the price of the Participant's products, the volume of its sales, the receipt of invoices priced in foreign currency, and the cost of materials and services purchased when translated to U.S. dollars for reporting purposes.

Under Contract 1, Captive agrees to:

> indemnify [Participant] for the amount of Loss of Earnings [Participant] sustain[s] due to decrease in the value of Specified Foreign Currency relative to the U.S. dollar. The covered amount of Loss of Earnings will be measured in U.S. dollars as the percentage increase in the Rate of Exchange of the U.S. dollar against the Specified Foreign Currency between the effective date and the expiration date as specified within the declarations endorsements, multiplied by the Coverage Limit.

Contract 1 includes the following definitions:

> <u>Coverage Limit</u> means the lesser of (1) the Specified Loss Limit (for each [Participant]) as listed within the declarations endorsements or (2) such [Participant]'s sales revenue received or accrued in the Specified Foreign Currency during the Policy Period (as defined in the declarations) as measured by translation into U.S. dollars at foreign currency exchange rates that are reflected in such [Participant]'s financial statements.
>
> <u>Loss of Earnings</u> means the percentage increase in the Rate of Exchange of the U.S. dollar against the Specified Foreign Currency between the

[1] We offer no opinion whether these risks are insurable risks or whether the structure of the arrangement between the members of Taxpayer Group and Captive with respect to these risks is insurance for federal income tax purposes.

> effective date and expiration date as stated within the declarations endorsements, multiplied by the Coverage Limit.
>
> The Rate of Exchange of the U.S. dollar against the Specified Foreign Currency means the spot price as quoted by Bloomberg LP at 10:00 a.m. EST on the effective day of each declarations endorsement.
>
> Premium means the Rate of Premium multiplied by the Coverage Limit.
>
> The Rate of Premium per dollar of coverage means two times the amount of premium as quoted by Bloomberg LP at 10:00 EST on the effective day of each declarations endorsement, as a percentage of notional for a 12-month call option contract for the purchase of U.S. dollars against Specified Foreign Currency.

Contract 1 also provides for a retrospective premium adjustment as follows: "The Premium shown in each of the declarations endorsements is a deposit Premium only and is the maximum [the Participant] will pay. The actual Premium will be subject to adjustment after the expiration date of each declaration endorsement, based on [the Participant]'s actual loss experience."

Under Contract 1, the retrospective premium adjustment is calculated as "[Number A]% of the deposit Premium, minus paid losses in excess of [Number B]% of the deposit Premium."[2] The effect of the adjustment "in no case shall … result in a final premium that exceeds the deposit Premium" and "if the retrospectively adjusted premium is less than the deposit Premium, [Captive] will refund the difference to [Participant] within [Number D] days of the end of the term outlined in the applicable declaration endorsement."

Under Contract 2, Captive agrees to:

> indemnify [Participant] for the amount of Loss of Earnings [Participant] sustain[s] due to an increase in the value of Specified Foreign Currency relative to the U.S. dollar. The covered amount of Loss of Earnings will be measured in U.S. dollars as the percentage decrease in the Rate of Exchange of the U.S. dollar against the Specified Foreign Currency between the effective date and expiration date as specified within the declarations endorsements, multiplied by the Coverage Limit.

Contract 2 includes the following definitions:

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[2] Upon an early termination, the determination of retrospective adjusted premium differs to achieve a proration between the duration of coverage and the period not to be covered; in such case the adjusted premium will not be less than Number C% of the deposit Premium regardless of the duration of coverage.

> Coverage Limit means the Specified Loss Limit (for each [Participant]) as listed within the declarations endorsements.
>
> Loss of Earnings means the percentage decrease in the Rate of Exchange of the U.S. dollar against the Specified Foreign Currency between the effective date and expiration date as stated within the declarations endorsements, multiplied by the Coverage Limit.

Contract 2 uses the same definitions for Rate of Exchange, Premium, and Rate of Premium as in Contract 1. Contract 2 also uses the same retrospective premium adjustment mechanism as in Contract 1.

Taxpayer explains that the Bloomberg option was chosen as the benchmark for determining the Premium for both Contracts because although the Contracts differ from the referenced option, the risks are comparable. Taxpayer offered that the purpose of this premium methodology, under which the Rate of Premium and maximum premium payable are double the market rate for an option providing similar risk protection, is to bolster the financial capacity of Captive so that Captive would have an additional source of funding for losses. Taxpayer previously offered that this methodology would be used initially but as the program gathered experience the pricing would use sound actuarial principles based on the experience of the Participants. However, although the Contracts have been in place since Year 1, it appears the Contracts continue to be implemented using the original, options-based, pricing methodology.

Notably, neither Contract describes the term “Specified Loss Limit.” However, representatives of Taxpayer indicated to the Service that Contract 1 generally has been implemented as if Specified Loss Limit was equal to the Participant’s export sales for the prior year, though apparently the limit was modified on an interim basis (the reason and extent of modification are not clear). Representatives of Taxpayer indicated that Contract 2 has been implemented as if the Specified Loss Limit was equal to the amount of each Participant’s outstanding loans at the endorsement effective date.

The Contracts each cover a policy period of one year with monthly endorsements extending the coverage of both Contracts. That is, the Contracts were initially issued for the period of Date A, Year 2, through Date B, Year 3, but beginning with the month after Date A, Year 2, an endorsement was added to provide coverage for the following year from that date. For example, if a Contract was issued on January 1, an endorsement would be added effective February 1 expiring January 31 of the following year. In effect, for each calendar year Taxpayer has 12 separate contracts, one becoming effective each month and one expiring each month. Taxpayer asserts that by staggering the purchase of foreign currency exchange risk coverage in this manner, each Participant obtains protection against the trend of a strengthening or weakening dollar (whichever side the coverage responds to).

Outside Actuary performed Actuarial Review, noting that the coverage limits for the Contracts are "derived as a function of the prior year production for each [Participant], separately." With respect to the premium structure:

> The final premiums are a function of both the currency options market 1 year call premium and the actual loss experience as adjusted by the retro premium feature. The deposit premium rates are determined as twice the 1 year call option rate for each currency pair, separately.
>
> The retro premium adjustment is a risk sharing mechanism that recasts the final loss ratios most notably where actual losses are between [Number E]% and [Number F]% of the deposit premium amounts.

With regard to Contract 1, for Year 1, Number G entities participated, covering a total of Number H currencies; the average number of currencies covered per Participant was Number I. For Year 2, Number B entities participated, covering at total of Number J currencies; the average number of currencies covered per Participant was Number I. For Year 3, Number K entities participated, covering a total of Number L currencies; the average number of currencies covered per Participant was Number M.

With regard to Contract 2, for Year 1, Number N entities participated, covering a total of Number O currencies; the average number of currencies covered per Participant was Number O. For Year 2, Number P entities participated, covering a total of Number O currencies; the average number of currencies covered per Participant was Number N. For Year 3, Number M entities participated, covering a total of Number O currencies; the average number of currencies covered per Participant was Number N.

The Contracts have features commonly found in insurance policies, such as the format and language, the payment of consideration, and the administration of claims of covered loss. In addition, the Contracts exclude any loss which is covered under property insurance or business interruption insurance. The Contracts do not mention any parental guarantee or premium loan back that could be inconsistent with a bona fide insurance arrangement.

For Year 1, a previous taxable year, we concluded in CCA 201511021 that the Contracts were not insurance because the Contracts lacked insurance risk and that the Contracts were also not insurance in its commonly accepted sense. In light of <u>R.V.I. Guaranty Co., v. Commissioner</u>, 145 T.C. 209, 245 n22 (2015), we have reconsidered our analysis.

<u>LAW AND ANALYSIS</u>

Neither the Internal Revenue Code nor Treasury regulations define "insurance" for federal income tax purposes. <u>R.V.I. Guaranty Co.</u>, 145 T.C. at 224-25. Courts have held that a captive insurance arrangement among affiliates can constitute insurance for federal income tax purposes where the arrangement satisfies the following elements: (1) the arrangement must involve insurable risks; (2) the arrangement must shift the risk of loss to the insurer and distribute the risks among the policyholders; and (3) the arrangement must be insurance in its commonly accepted sense. Rent-A-Center, Inc. v. Commissioner, 142 T.C. 1, 21 (2014); Sears, Roebuck & Co. v. Commissioner, 96 T.C. 61, 101 (1991), aff'd in part and rev'd in part, 972 F.2d 858 (7th Cir. 1992); AMERCO, Inc. & Subs. v. Commissioner, 96 T.C. 18, 38 (1991), aff'd, 979 F.2d 162 (9th Cir. 1992); Harper Group v. Commissioner, 96 T.C. 45, 58 (1991), aff'd, 979 F.2d 1341 (9th Cir. 1992). Courts consider "all of the facts and circumstances to determine whether an arrangement qualifies as insurance." Rent-A-Center, 142 T.C. at 22 (citing Harper Group, 96 T.C. at 57).

Whether a risk is an "insurable risk" is examined from the perspective of both the insured and insurer. R.V.I. Guaranty Co., 145 T.C. at 225 (citing Harper Group, 96 T.C. at 57). Not all risks faced by a business are insurable. The Tax Court has observed that "[i]nsurance risk is involved when an insured faces some loss-producing hazard (not an investment risk), and an insurer accepts a payment, called a premium, as consideration for agreeing to perform some act if and when that hazard occurs." R.V I. Guaranty Co., 145 T.C. at 235 (quoting Black Hills Corp. v. Commissioner, 101 T.C. 173, 182 (1993), aff'd, 73 F.3d 799 (8th Cir. 1996)). Typically, the loss produced by the occurrence of the hazard must be an economic loss. Allied Fidelity Corp. v. Commissioner, 66 T.C. 1068 (1976), aff'd, 572 F.2d 1190, 1193 (7th Cir. 1978), cert. den., 439 U.S. 835 (1978).

Central to the notion of insurance risk is the concept of a "fortuitous event." AMERCO, 979 F.2d at 167. A fortuitous event is "[a] happening that, because it occurs only by chance or accident, the parties could not reasonably have foreseen." Black's Law Dictionary 725 (9th ed. 2009). In order for an arrangement to constitute insurance, the arrangement must involve the fortuitous occurrence of a stated contingency, Commissioner v. Treganowan, 183 F.2d 288, 290-91 (2nd Cir. 1950), cert. den., 340 U.S. 853 (1950), and must not merely involve an investment or business risk. Helvering v. Le Gierse, 312 U.S. 531, 542 (1941); Rev. Rul. 2007-47, 2007-2 C.B. 127; Rev. Rul. 89-96, 1989-2 C.B. 114. That the risk may be mitigated through a mechanism other than insurance does not mean the risk is not an insurance risk. R.V.I. Guaranty, 145 T.C. at 245. Moreover, nontax regulatory treatment of the risk and the arrangement to mitigate the risk as insurance is highly probative. Id. at 237-38, 245-46.

Risk shifting occurs if a person facing the possibility of an economic loss transfers some or all of the financial consequences to an insurer, such that a loss does not affect the insured because the loss is offset by a payment from the insurer. Rev. Rul. 2005-40, 2005-2 C.B. 4. The arrangement addressed in this memorandum is described as a "brother-sister arrangement" because it involves an arrangement between affiliated subsidiaries of Taxpayer (here, the Participants) and another subsidiary of Taxpayer that is the insurer (here, the Captive). See, e.g., Rent-A-Center, 142 T.C. at 16 (considering the deductibility of premiums paid by affiliated subsidiaries to a captive in a brother-sister arrangement). Such an arrangement can shift risk from the affiliated subsidiaries to the captive even if the aggregate net worth of all of the affiliated subsidiaries of a parent corporation is not affected by an incurred loss. Id. at 20-21. However, among the conditions predicate for risk shifting is that the entity assuming the risk, the captive, be "financially capable of meeting its obligations". Id. at 31; see also Malone & Hyde, Inc. v. Commissioner, 62 F.3d 835, 842-43 (6th Cir. 1995) (either undercapitalization or indemnification of the insurer by the taxpayer claiming the deduction, or both, precludes risk shifting to the insurer).

Risk distribution occurs when an insurer pools a large enough collection of unrelated risks (those unaffected by the same event) and distributes the risks among the policyholders. Rent-A-Center, 142 T.C. at 24; Avrahami v. Commissioner, 149 T.C. No. 7, at 60. A captive may achieve adequate risk distribution by insuring only subsidiaries within its affiliated group. Id. But see Rev. Rul. 2005-40, 2005-4 C.B. 4 (holding that where only one entity participates as the insured, the arrangement lacks sufficient risk distribution). In analyzing risk distribution, there must be both a sufficient number of insured companies as well as a sufficient number of independent risk exposures. Avrahami, 149 T.C. No. 7 at 63-64. In Avrahami, the court held that since the captive insured only 3 or 4 insured entities, the captive failed to adequately distribute risk. Id. In addition, the captive did not cover a sufficient number of risk exposures to achieve risk distribution merely through its affiliated entities (issuing 7 types of direct policies). By contrast, the court found sufficient risk distribution in R.V.I., which used 951 policies covering 714 different insured entities with more than 750,000 vehicles, 2,000 parcels of real estate, and 1.3 million equipment assets. The court also found sufficient risk distribution in Rent-A-Center, 142 T.C. 1, where the arrangement covered approximately 15 affiliated subsidiaries,[3] more than 14,000 employees, 7,100 vehicles, and 2,600 stores in all 50 States. See also, Securitas Holdings, Inc. v. Commissioner, T.C. Memo. 2014-255. Here, the number of Participants in, and the currencies covered by Contract 1, varied each year; the number of Participants in Contract 2 varied each year. Whether these Contracts involved a sufficient number of insured companies as well as a sufficient number of independent risk exposures to achieve risk distribution is not clear.

The determination of whether an arrangement fits within the "commonly accepted sense" of insurance is made by weighing certain nonexclusive factors. These nonexclusive factors include whether (1) the insurer is organized, operated, and regulated as an insurance company by the States in which it does business; (2) the insurer is adequately capitalized; (3) the insurance policies are valid and binding; (4) the premiums are reasonable in relation to the risk of loss; and (5) the premiums are duly paid and loss claims are duly satisfied. See, e.g., R.V.I. Guaranty, 145 T.C. at 231 (citing Harper Group, 96 T.C. at 60; Securitas Holdings, T.C. Memo. 2014-225). An insurer may be considered adequately capitalized if it meets the minimum capital requirements of its regulator. See Avrahami, 149 T.C. No. 7, at 70, 76 (however, the

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[3] The opinion does not provide additional detail regarding the number of entities.

court concluded that Pan American was not a *bona fide* insurance company, even though it met the Island of Nevis' "loosely regulated [ ] low capitalization requirements").

In this case, the adverse movement of foreign currency valuations presents the possibility of an economic loss. The movement of the foreign currency valuation could be a fortuitous event.[4] Accordingly, given the role of currency fluctuation in the Participants' business, we conclude that foreign currency risk can be an "insurance risk," though this arrangement bears resemblance to a notional principal contract or other type of a § 988 transaction.

For each Contract the foreign currency risk is seemingly shifted from each Participant to Captive. While Contract 1 and Contract 2 nominally cover opposite risks, it appears no Participant was simultaneously covered by both Contracts with respect to the same foreign currency risk; hence under no scenario would the risk be neutralized. Cf., Le Gierse, 312 U.S. at 541 (combination of contracts neutralizing risk). However, whether this risk was distributed, particularly with respect to Contract 2, is unclear. Further development is necessary to evaluate whether the arrangement, in particular Contract 2, involves the pooling of a large enough collection of unrelated risks to utilize the "statistical concept that theorizes that the average of a large number of independent losses will be close to the expected loss." Avrahami, 149 T.C. No. 7 at 60.

Captive is regulated by State as a pure captive insurance company. Premiums are also duly paid and loss claims are duly satisfied. In addition, Taxpayer offered that the purpose of the premium methodology, under which the Rate of Premium and maximum premium payable are double the market rate for an option providing similar risk protection, is to bolster the financial capacity of Captive so that Captive would have an additional source of funding for losses, though Captive may meet the capital requirements of State and may be adequately capitalized, cf., Avrahami, 145 T.C. No. 7 at 80.

Taxpayer, however, has not demonstrated that the arrangement constitutes insurance in its commonly accepted sense, as understood in Avrahami, 149 T.C. No. 7 at 76; R.V.I. Guaranty, 145 T.C. at 231, and other decisions. Though the Contracts follow a policy form, an essential term of the agreement, the coverage limit, is on its face ambiguous. The Contracts state that coverage is provided up to the Specified Loss Limit, but that term is not defined in the Contracts. Whether the Specified Loss Limit can be inferred from the conduct of the parties is unclear given that, at least in the case of Contract 1, the conduct of the parties apparently has not been entirely consistent. Specifically, the parties modifed the meaning of the term on an interim basis without explanation. Cf., Restatement (Second) of Contracts, § 220 (agreement interpreted in accordance with known relevant usage).

[4] The information provided does not suggest that the Participants have the legal or economic ability to meaningfully influence any currency valuation.

In addition, no documentation has been provided showing that the premiums are set at arm's length or priced using insurance experience. Captive's premium methodology for the Contracts, which steeply retrospectively rates a multiple of the commercially available option price, may not be typical of commercial insurance practice.

Moreover, the Contracts' coverage does not appear to match Participants' risk of loss. Here, the results under the Contracts do not tie to the actual exposure of Participants to particular foreign currencies; Taxpayer and Captive acknowledge that the results under each Contract are "determined independently of the actual value of loss." Indeed, under these Contracts it seems Participants may both have currency gains over the life of a particular transaction (or group of covered transactions) and also be eligible for a benefit under the Contracts (e.g., the currency could move favorably over the time of the Participant's exposure to the currency but also unfavorably when measured over the one-year duration of a Contract), such that the risk involved may to some extent be described as speculative. See e.g., 7 Couch on Ins. § 101:2 (wagering is not insurance); 17 Couch on Ins. § 246:93 (insurance not for speculative purposes). 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 suggests that the insurable interest may not be substantial in relation to the amount of insurance. See, e.g., 3 Couch on Ins. § 41:2 (stating that the extent of insurable interest is typically not evaluated and it is immaterial that the interest of the insured is overvalued as long as the actual interest is substantial in relation to the amount of the insurance). In addition, this sequential laddering may be inconsistent with prevailing commercial practice for insurance contracts.

Accordingly, we cannot conclude that the material provided by Taxpayer and Captive demonstrates that either Contract 1 or Contract 2 satisfy each prong of the definitional test of insurance for federal income tax purposes.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

[redacted]

[redacted]

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