Chief Counsel Advice determines that a captive insurer's indemnification of losses caused by foreign currency fluctuations is not insurance

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In brief

In Chief Counsel Advice ("CCA") 201511021, the IRS concluded that contracts issued by a captive insurance company indemnifying related taxpayers for loss of earnings caused by foreign currency fluctuations did not constitute insurance for federal tax purposes, as the arrangement lacked insurance risk and was not insurance in its commonly accepted sense.

In detail

In the CCA, Taxpayer Group conducts its business worldwide through U.S. and foreign subsidiaries. Taxpayer Group includes a captive insurance company ("Captive"). Taxpayer is the ultimate parent ("Parent") of Taxpayer Group.

Captive provided various types of coverage to Taxpayer Group. As a result of foreign exchange effects on its global operations, Parent entered into an arrangement with Captive on behalf of certain of its subsidiaries ("participating members"), whereby Captive agreed to indemnify the participating members for loss of earnings suffered due to fluctuations in currencies relative to the U.S. dollar. No one participating member accounted for more than 15 percent of the premiums paid to the Captive.

The contracts covered any "loss of earnings" resulting from a decrease or increase in the value of the specified foreign currency up to the stated coverage limits. Taxpayer represented that the loss of earnings did not represent the actual loss but a reasonable approximation.

To determine whether the arrangement constituted insurance for federal tax purposes the IRS applied the three-prong test in *Amerco, Inc. v. Commissioner*, 96 T.C. 18 (1991), *aff'd* 979 F.2d 162 (9th Cir. 1992). Under that test, to qualify as insurance there must be (i) an insurance risk, (ii) risk shifting and risk distribution, and (iii) insurance in its commonly accepted sense. The IRS determined that the contracts did not constitute insurance contracts as they lacked insurance risk and were not insurance in its commonly accepted sense.

The IRS examined the substance of the arrangements and reasoned that the risk of loss from exchange rate fluctuations was an investment or business risk more commonly mitigated by derivative contracts.

Further, according to the IRS the contracts were not insurance in its commonly accepted sense as they did not contemplate a casualty event; the loss was payable on contract termination

which the IRS determined is not a casualty event.

The takeaway

Although not precedential, the CCA provides an example of an arrangement with a captive insurance company that the IRS determined did not qualify as insurance for federal tax purposes despite recent taxpayer-favorable judicial authorities. The CCA is particularly interesting because the IRS is currently litigating a case (*RVI Guaranty Company, Ltd. v. Commissioner*, Dkt. No. 27319-12) in Tax Court which would consider whether residual value insurance entails a business risk or an insurance risk. The issues raised in that case are similar to those in the CCA in the sense that both involve risk with respect to value. The CCA serves as a useful reminder that although the three-prong test for insurance is well established, the line between a business risk and an insurance risk is sometimes far from clear.

Let's talk

For more information on how this Chief Counsel Advice Memorandum could affect your business, please contact one of the individuals listed below:

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