The RVI Case: Court Deference To State Regulators & Outside Advisors Blunts The IRS Attack

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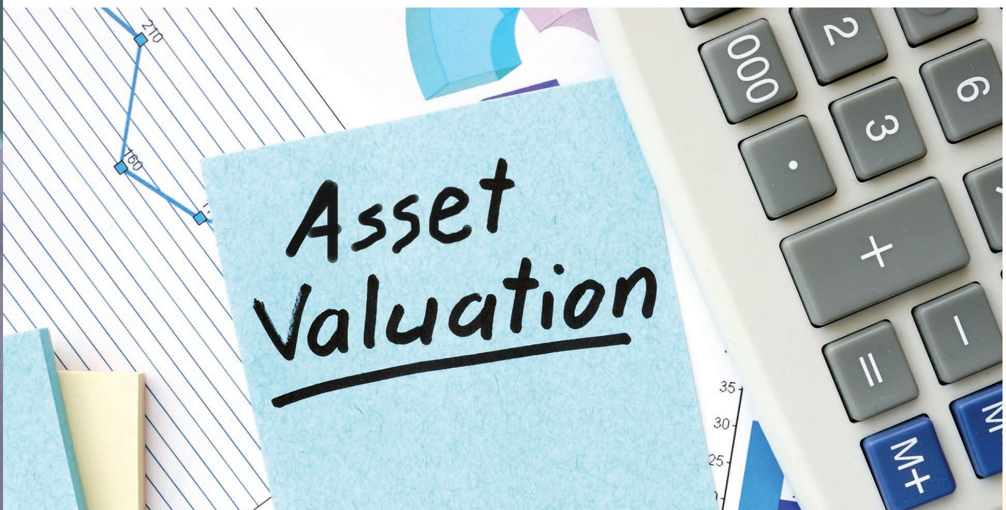
Companies that lease assets compute "residual value" – the value that remains after a lease term – for numerous purposes. Regardless of the



reason for the computation, there are several reasons why the original computation could be wrong. For example, technological obsolescence could lower an asset's value. A massive recession could lower the value of all capital assets at the macro-economic level. An industry could begin an overall state of decline, lowering the attractiveness of all assets in that sector.

None of the three preceding events are included in standard residual value computations, making their inclusion in RVI computations suspect to the IRS.

Insuring Against Lower Residual Value

In the event the final residual value at the end of the lease is lower than originally calculated, the asset owner would show a loss totaling the difference between the two figures. To insure against this event, companies regularly purchase "residual value insurance" from such large, nationally recognized insurers as AIG and Chubb.

A Connecticut insurer named R.V.I. ("RVI") was another company selling this policy. Their premiums were inexpensive; each $100 of insurance was usually priced at $4. So, if a car lessor wanted to buy $1,000 of insurance, they would only spend $40.

The IRS argued that these policies were not insurance for tax purposes.

The IRS Motivation & Argument

Regarding the IRS's motivation for filing this case, one observer noted, "We can do little more here than to presume that somebody at the Service was stuck on the idea that residual value policies were not insurance, but investment contracts, and they couldn't be un-stuck other than to be proven wrong in court." [1]

A recently released IRS Internal Legal Memorandum supports this point. [2] In that memo, a captive attempted to write a policy covering the insured for losses related to currency transactions. The memo argued insurance could only cover risks that did not regularly occur in the insured's everyday business operations. They offered the following factors to guide taxpayers in future casts:

1. What are the ordinary activities of a business enterprise?
2. What are the typical activities and obligations of running a business?
3. Is the action that might be covered by a policy in the control of the insured

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within a business context?

4. Is the economic risk involved a market risk that is part of the business environment?
5. Is the insured required by a law or regulation to pay for the covered claim?
6. Is the action in question willful or inevitable?

The Service determined that the risk of an asset's end-of-useful-life value being below its pre-transaction calculated value was a business risk for which insurance was not available. Factors one, two and four from the memo support that conclusion.

The Court Applies Harper

The court disagreed, ruling the policies were insurance. They utilized the Harper test to frame their analysis. Under Harper, a captive must comply with the following three factors:

1. Whether the arrangement involves the existence of an "insurance risk";
2. Whether there was both risk shifting and risk distribution; and
3. Whether the arrangement was for "insurance" in its commonly accepted sense.[3]

They began with an analysis of risk shifting and risk distribution. Risk shifting requires the insured to transfer the risk to a third party – namely, the insurer. In the insurance context, the insured's premium payment and the insurer's issuing a policy create sufficient evidence to show shifting occurred. The court also noted the importance of the insurer having sufficient capital to pay claims. While this might seem a foregone conclusion, it's important to remember that, in signing the contract, the insurer promises to indemnify the insured. Sufficient capital is prima facie evidence the insurer can fulfill his obligation.

They next analyzed risk distribution, which requires the insurer to distribute the risk of loss over a sufficiently large pool of risk such that an indemnification payment is not made of the insured's funds. Here, RVI wrote policies covering 754,532 autos, 2,097 commercial real estate projects and 1.4 million pieces of industrial equipment. In addition, the policies covered a large geographic and temporal range. The court described this pool as "vast" and ruled it created sufficient risk distribution for insurance to exist.

To determine the compliance of the transaction with Harper's "commonly accepted notion of insurance," the court looked at the following factors:

1. Whether the insurer is organized, operated, and regulated as an insurance company by the States in which it does business;
2. Whether the insurer is adequately capitalized;
3. Whether the insurance policies are valid and binding;
4. Whether the premiums are reasonable in relation to the risk of loss; and
5. Whether premiums are duly paid and loss claims are duly satisfied.

State Regulator Deference

The court found the first factor to be especially important for two reasons. First, Congress delegated insurance regulation to the various states under the McCarran-Ferguson Act. Second, four earlier captive cases placed a similar weight on state regulation to determine whether or not the captive was in fact a bona fide insurer.

In the case of RVI, the insurer was originally organized and subsequently regulated by the Connecticut Department of Insurance. Not only did the state examine the insurer's original business plan to determine validity, they also annually reviewed the company's financial and basic operations, never finding a problem. In addition, the company had to register in all states where it sold policies, each of which performed similar tasks. The court found the issuance of insurance contracts

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that complied with the standard industry format satisfied the remaining elements listed above.

The Service attempted to argue that the insurance policies did not cover insurance risk, but, in the words of the court, were analogous to "a stock investor's purchase of a put option." This was a somewhat perplexing argument. The court noted that New York and Connecticut statutorily ruled that RVI was insurance.

Washington State allowed a similar policy. The court also observed that in 1933 the Pennsylvania Supreme Court ruled that policies covering the insured for a decline in real estate value – a very similar risk -- was insurance. In short, ample precedential evidence existed to counter the Service's assertion.

Outside Advisor Deference

One of the most important points from the case was the court's reliance on outside advisers to validate the transaction. One industry observer noted the importance of actuaries' expert testimony:

> As interesting as the key elements of the decision are, the importance of the expert testimony of actuaries from the CAS [Casualty Actuarial Society] cannot be overlooked. … In the RVI case, two leading members of the CAS played instrumental roles. Current CAS President, Bob Miccolis, of Deloitte Consulting, and former American Academy of Actuaries Casualty Practice Council Vice President, Mike Angelina, who currently serves as executive director of the Academy of Risk Management and Insurance at Saint Joseph's University, were essential to the success of RVI's case. On the essential issues of risk transfer/shifting, risk distribution, commonly accepted notions of insurance, and the definition of insurance risk, their testimony was critical and was often specifically cited in the opinion.[4]

The continued monitoring of the insurer by other professionals was also determinative. The court specifically noted Connecticut actuary contacted the company's actuary to discuss assumptions about the RVI policies, and the state's actuary raised no concerns. Finally, the ruling noted that outside auditors could not sign off on the annual audit unless they concluded the company bore "significant" insurance risk.

Conclusion:

The most important potential outcome of this case is that a U.S. formed captive that remains compliant with the domicile's law and regulations could go a long way to establishing compliance with the Harper test. For example, all major US jurisdictions require a captive applicant to submit an independent actuary report, which, at minimum, is reviewed by the domicile. Sometimes they will hire an independent auditor to review the applicant's actuarial conclusions. The captive must also submit a general business plan, corporate documents and insurance policies.

Annually, each captive must be independently audited, which like the auditing firm in RVI, requires a third party to attest the captive is underwriting bona fide risk. The domiciles review these reports, looking for potential violations of state law. In short, no less than three independent parties (an actuary, an auditor and the state regulator) review the captive transaction with an eye to determine if the transaction establishes a bona fide insurer.

Footnotes:

[1] Jay Adkisson, Residual Value Insurance Scores Big Win in tax Court, Forbes, Sept. 28, 2015

[2] ILM 201511021

[3] Harper Groups Subsidiaries v. Comm'r, 96 T.C. 45, 58 (T.C. 1991)

[4] Rob Walling, RVI v. IRS – An Important Case for Insurers and Actuarial Experts, Published October 8th, 2015 on the Pinnacle Actuaries Blog

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