What is Insurance?

F&I Reinsurance and Product Conference
by

Lawrence Prudhomme, CPA, ACI
Vice President
GPW and Associates, Inc.

Kirk Borchardt
Executive Vice President & Chief Legal Counsel
Dealers Assurance Company

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What is Insurance?

Insurance is not defined by the Internal Revenue Code or regulations; definition comes from case law:

- **Helvering v. LeGierse** - established three key criteria for insurance
  - Risk Shifting
  - Risk Distribution
  - Follows commonly accepted sense and notions of insurance
- **Harper v. Commissioner** – an insured should face some hazard. If no risk exists, then insurance cannot be present
- **Humana v. Commissioner** – defines risk shifting within an economic family (i.e. parent/ subsidiaries)
- **Revenue Rulings 2002-89 and 2002-90** – describes situations where risk distribution is either achieved or not achieved
- **Revenue Ruling 2002-91** – addresses both risk shifting and risk distribution

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What is Insurance?

Insurance for tax purposes is not necessarily insurance for state regulatory purposes

- Promise to **pay** or **indemnify** is likely insurance (i.e. extended service contracts, GAP)
- Promise to **repair**, **restore** or **waive** likely not insurance (i.e. prepaid maintenance, debt waiver)

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Elements of Insurance

Risk Transfer

- There must be the involvement of an insurance risk (two outcomes)
  - Loss
  - No loss
- The risk transferred must be a risk of economic loss
- The risk must contemplate the fortuitous occurrence of a stated contingency (the event will not inevitably occur)
- It cannot be merely an investment or business risk (three outcomes)
  - Loss
  - No loss
  - Profit

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Fortuity

- Relating to fortune or chance
- Loss has not yet occurred
- Loss is not guaranteed to occur
- **Harper V. Commissioner**: "An insured faces some hazard; an insurer accepts a premium and agrees to perform some act if or when the loss event occurs. If no risk exists, then insurance cannot be present."

Fortuitous	Not Fortuitous
Car Skids on Black Ice	Deliberate Car Crash
Accidental Fire	Arson (by covered party)
Mechanical Breakdown	Inherent Defect
Future Event	Past Event

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Elements of Insurance

Risk Distribution

Risk distribution incorporates the statistical phenomenon known as the ***Law of Large Numbers*** – distributing risk allows the insurer to reduce the possibility that a single costly claim will exceed the amount taken in as a premium and set aside for the payment of such a claim.

The ***Law of Large Numbers*** is a statistical concept that the larger the sample size and more times an experiment is repeated (or a sample is taken) the more closely predictions made from that data will match the actual population or outcome. The larger the sample and the more samples taken the better the ability to predict expected future outcomes.

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Law of Large Numbers

- Recent cases looked at the **Law of Large Numbers** when determining if there was risk distribution
  - **Rent-A-Center V. Commissioner**
    - Between 2,623 and 3,081 Stores
    - Between 14,300 and 19,740 Employees
    - Between 7,143 and 8,027 Insured Vehicles
  - **Securitas Holdings V. Commissioner**
    - Between 48,000 and over 200,000 Employees
    - Between 2,250 and 2,495 Vehicles

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Insurance in the Commonly Accepted Sense

- Payment or Premium
- Written Contract or Policy
- Standard Policy Terms and Exclusions
- Organize and Operate like Insurance Company
- Regulated as Insurance by State
- Expectation of Profit and Risk of Loss
- Fortuity
- Non-Tax Business Purpose

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Standard Policy Terms and Exclusions

- Coverage Period
- Deductible
- Copayment
- Policy Limit
- Specifics of Items Covered by Policy (ex. VIN)
- Exclusions
  - Deliberate Damage
  - Use in Illegal Activity
- Refunds/Cancellation

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Polling Question

Which of the following is not a fortuitous event?

A. Mechanical Breakdown
B. Car Accident
C. Inherent Defect in Manufactured Product
D. Theft of Vehicle

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Questions

Lawrence Prudhomme, CPA, ACI
Vice President
GPW and Associates, Inc.
3101 N. Central Avenue, Suite 400
Phoenix, AZ 85012
602.200.6900
lprudhomme@gpwa.com
www.gpwa.com

Kirk Borchardt
Executive Vice President & Chief Legal Counsel
Dealers Assurance Company
2040 Alameda Padre Serra, Suite 102
Santa Barbara, CA 93103
805.963.2983
kborchardt@dealersassurance.com
www.dealersassurance.com

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