Part I

Section 162.—Trade or Business Expense

26 CFR 1.162-1: Business Expenses
(Also §§ 461; 831.)

Rev. Rul. 2007-47

ISSUE

Does the arrangement described below involve the requisite insurance risk to constitute insurance for purposes of determining (i) whether X may deduct the amount paid under the arrangement as an "insurance premium" under § 162 of the Internal Revenue Code, and (ii) whether IC may account for the arrangement as an "insurance contract" for purposes of subchapter L of the Code?

FACTS

X, a domestic corporation that uses an accrual method of accounting, is engaged in a Business Process that is inherently harmful to people and property. Applicable governmental regulations require X to take action to remediate that harm. Doing so will require X to incur Future Costs to undertake specific measures to restore X's business location to its condition before Business Process began; the Future Costs will be

incurred when X ceases to engage in Business Process. The exact amount and timing of the Future Costs are a function of many factors, including the future cost of wages, future cost of materials, future changes in the regulation of Business Process, and the timing of X's discontinuation of Business Process. There is no uncertainty, however, that the Future Costs will be incurred.

When X began Business Process in Year 1, it estimated that the present value of Future Costs was $150x, based on its evaluation of the factors identified above and an appropriate discount rate based on economic projections. At that time, X entered into an arrangement with IC, an unrelated domestic insurance company taxable under § 831. Under the arrangement, X agreed to pay IC $150x, and IC agreed to reimburse X for its Future Costs, up to a limit of $300x. The arrangement had no limits on its duration.

LAW

Section 162(a) provides, in part, that there shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business. Section 1.162-1(a) of the Income Tax Regulations provides, in part, that among the items included in deductible business expenses are insurance premiums against fire, storm, theft, accident, or other similar losses in the case of a business.

Section 461 provides that the amount of any deduction shall be taken for the taxable year which is the proper taxable year under the method of accounting used by the taxpayer in computing taxable income. Under § 1.461-1(a)(2), a liability is incurred

and generally is taken into account under an accrual method of accounting in the taxable year in which all the events have occurred that establish the fact of the liability, the amount of the liability can be determined with reasonable accuracy, and economic performance has occurred with respect to the liability. Section 1.461-4(g)(5) provides that if a liability arises out of the provision to the taxpayer of insurance, economic performance occurs as payment is made to the person to which the liability is owed. If the period of coverage extends substantially beyond the close of the taxable year, however, the amount permitted to be taken into account in the year of payment is determined under the capitalization rules of § 263. Section 1.461-4(g)(8)(Ex. 6); § 1.263-4(d)(3)(i).

Characterization of an arrangement as insurance has consequences for the issuer, as well. Section 831(a) provides that taxes, computed as provided in § 11, are imposed for each taxable year on the taxable income of each insurance company other than a life insurance company. Section 832(a) provides that for this purpose, taxable income means the gross income as defined in § 832(b)(1) less the deductions allowed by § 832(c). Gross income includes underwriting income, which is defined in § 832(b)(3) as premiums earned on insurance contracts during the taxable year, less losses incurred and expenses incurred. Premiums earned and losses incurred on insurance contracts are computed taking into account reserves for unearned premiums under § 832(b)(4) and for discounted unpaid losses under § 832(b)(5), respectively. If an arrangement is not an insurance contract, no reserves are permitted for unearned premiums or for discounted unpaid losses with respect to the arrangement. Even if an

arrangement is an insurance contract, no reserve is permitted for discounted unpaid losses until a loss has been "incurred."

Neither the Code nor the regulations define the terms “insurance” or “insurance contract.” The Supreme Court of the United States has explained that in order for an arrangement to constitute insurance for federal income tax purposes, both risk shifting and risk distribution must be present. Helvering v. Le Gierse, 312 U.S. 531 (1941). The risk transferred must be risk of economic loss. Allied Fidelity Corp. v. Commissioner, 572 F.2d 1190, 1193 (7th Cir. 1978). The risk must contemplate the fortuitous occurrence of a stated contingency, Commissioner v. Treganowan, 183 F.2d 288, 290-91 (2d Cir. 1950), and must not be merely an investment or business risk. Le Gierse, 312 U.S. at 542; Rev. Rul. 89-96, 1989-2 C.B. 114.

In Le Gierse, the Court found that complementary annuity and insurance contracts did not involve an insurance risk but rather an investment risk because the risk assumed by the issuer was only that the amount the taxpayer paid for the contracts would earn less than the amount paid to the taxpayer as an annuity; the total amount paid by the taxpayer exceeded the face value of the life insurance contract. This risk, the Court said, “was an investment risk similar to the risk assumed by a bank; it was not an insurance risk.” Le Gierse, 312 U.S. at 542.

In Treganowan, the court held that a program under which the surviving members of the New York Stock Exchange paid a certain sum to the families of deceased members constituted insurance; the court distinguished the holding of Le Gierse as follows:

> The holding [of Le Gierse] really highlights the situation here where the payment is actually conditioned upon death, whenever occurring, in the true terms of insurance. "From an insurance standpoint there is no risk unless there is uncertainty, or, to use a better term, fortuitousness. It may be uncertain whether the risk will materialize in any particular case. Even death may be considered fortuitous, because the time of its occurrence is beyond control." 8 Ency.Soc.Sc. 95. That fortuitousness, whether we speak of death generally or premature death, as the Tax Court wished to emphasize, seems perfectly embodied here to fit both branches of the Supreme Court's test.

Treganowan, 183 F.2d at 290-91. See also Allied Fidelity Corp., 572 F.2d at 1193 ("[T]he insurer undertakes no present duty of performance but stands ready to assume financial burden of any covered loss," citing Couch on Insurance § 1:2 (1959)).

The Supreme Court has applied a similar standard to determine what constitutes "the business of insurance" for purposes of § 2(b) of the McCarran-Ferguson Act, 59 Stat. 34, as amended, 61 Stat. 448, 15 U.S.C. § 1012(b). In Group Life & Health Ins. Co. v. Royal Drug Co., 440 U.S. 205, 211 (1979), the Court concluded that agreements between Blue Shield of Texas and three pharmacies for the provision of prescription drugs to Blue Shield policyholders did not constitute "the business of insurance" within the meaning of the McCarran-Ferguson Act, noting that "[t]he primary elements of an insurance contract are the spreading and underwriting of a policyholder's risk." The Court considered the legislative history of the Act, quoting approvingly from one of the early House Reports, as follows: "'The theory of insurance is the distribution of risk according to hazard, experience, and the laws of averages. These factors are not within the control of insuring companies in the sense that the producer or manufacturer

may control cost factors.'" Group Life & Health Ins. Co., 440 U.S. at 221 (quoting H.R. Rep. No. 873, 78th Cong., 1st Sess., 8-9 (1943)). Non-tax insurance treatises further confirm that arrangements entered into to manage losses that are at least substantially certain to occur, or that are not the result of fortuitous events, do not constitute insurance. See, e.g., Couch on Insurance, § 102:8 (losses that exist at the time of the insuring agreement, or that are so probable or imminent that there is insufficient "risk" being transferred between the insured and insurer, are not proper subjects of insurance); 1 Appleman on Insurance 2d, § 1.4 ("The fortuity principle is central to the notion of what constitutes insurance. The insurer will not and should not be asked to provide coverage for a loss that is reasonably certain or expected to occur within the policy period."); 43 Am. Jur. 2d Insurance, § 479 (2005). See also Warren Freedman, Freedman's Richards on Insurance § 1:2 (6th ed. 1990)(insurance is an aleatory contract); Restatement (First) of Contracts § 291 (1932)(aleatory contract is one premised on happening of fortuitous event; that time or amount of performance depends on fortuitous event does not mean contract is aleatory).

In Rev. Rul. 89-96, 1989-2 C.B. 114, Y, a taxpayer that had already experienced a catastrophic loss, entered into a "liability insurance" contract with Z, an unrelated casualty insurance company. The exact amount of Y's liability to injured persons as a result of the catastrophe could not be ascertained, but was expected to be substantially in excess of $130x. At the time the catastrophe occurred, Y's liability insurance coverage totaled $30x. Under the contract between Y and Z, Y paid a premium of $50x in exchange for additional "liability insurance" coverage of $100x. That is, Z promised

to pay on behalf of Y amounts in excess of $30x for which Y would become liable, subject to the contract's limit of $100x. The $50x “premium” charged Y was an amount that, together with Z's investment earnings and tax savings, would yield at least Z’s maximum anticipated liability of $100x by the time claims were liquidated. The ruling concludes that the arrangement does not involve the requisite risk shifting necessary for insurance, because the catastrophe had already occurred and the economic terms of the contract demonstrate the absence of any risk apart from an investment risk (that is, the risk Z would be required to pay out $100x earlier than anticipated, or that actual investment yield would be lower than forecast).

ANALYSIS

In order to determine the nature of an arrangement for federal income tax purposes, it is necessary to consider all the facts and circumstances in a particular case, including not only the terms of the arrangement, but also the entire course of conduct of the parties. Thus, an arrangement that purports to be an insurance contract but that lacks the requisite insurance risk, or fortuity, may instead be characterized as a deposit arrangement, a loan, a contribution to capital (to the extent of net value, if any), an option or indemnity contract, or otherwise, based on the substance of the arrangement between the parties. The proper characterization of the arrangement may determine whether the issuer qualifies as an insurance company and whether amounts paid under the arrangement may be deductible.

In the present case, the requirement that X incur Future Costs attached at the time X began Business Process; no insurance risk or hazard, such as a hurricane or an

accident, exists as to whether X will have to incur those costs; it is certain that IC will have to perform under the arrangement with X by reimbursing X for the costs incurred to perform the measures, subject to the contract limit of $300x. Economically, the arrangement is a prefunding by X of its future obligations. Although IC assumed the risks of (i) the scope of the required measures, (ii) projections of future labor and material costs, (iii) the likely time frame when Future Costs would be incurred, and (iv) an appropriate discount rate based on projections of future investment earnings, the overall risk assumed by IC was whether the estimated present value of the cost of performing the measures ($150x) would accrue to exceed the greater of X's costs to perform the required measures or the contract limit of $300x. This risk is akin to the timing and investment risks that Rev. Rul. 89-96 concludes are not insurance risks. Accordingly, the arrangement between X and IC lacks the requisite insurance risk to constitute insurance under the authorities set forth above.

HOLDING

The arrangement between X and IC lacks the requisite insurance risk to constitute insurance for purposes of determining (i) whether X may deduct the amount paid under the arrangement as an "insurance premium" under § 162 of the Internal Revenue Code, and (ii) whether IC may account for the arrangement as an "insurance contract" for purposes of subchapter L of the Code.

EFFECT ON OTHER DOCUMENTS

Rev. Rul. 89-96, 1989-2 C.B. 114, is amplified.

REQUEST FOR COMMENTS

A revenue ruling represents the conclusion of the Internal Revenue Service (IRS) on the application of the law to the pivotal facts stated therein. Accordingly, this revenue ruling does not apply to reinsurance arrangements (including retroactive reinsurance, such as loss portfolio transfers), arrangements covering unanticipated environmental exposures, arrangements covering unanticipated cost overruns, or arrangements involving product warranties. The IRS may apply, or not apply, the authorities cited in this ruling to such arrangements, according to the facts and circumstances presented on a case-by-case basis. Comments are requested concerning the need for guidance in these and other areas. Comments should be submitted by October 22, 2007. Comments may be submitted by mail addressed to: Internal Revenue Service, CC:PA:LPD:PR (Rev. Rul. 2007-47), P.O. Box 7604, Ben Franklin Station, Washington, DC 20044; by hand delivery (Monday through Friday between the hours of 8:00 a.m. through 4:00 p.m.) addressed to: Courier's Desk, Internal Revenue Service, Attn.: CC:PA:LPD:PR (Rev. Rul. 2007-47), Room 5203, 1111 Constitution Avenue, NW, Washington, DC 20224; or by email addressed to: Notice.Comments@irscounsel.treas.gov. Commentators should include the identification number of the publication (Rev. Rul. 2007-47) in both the email subject line and the body of the comment.

DRAFTING INFORMATION

The principal author of this revenue ruling is John E. Glover of the Office of Associate Chief Counsel (Financial Institutions & Products). For further information regarding this revenue ruling, contact Mr. Glover at (202) 622-3970 (not a toll-free call).