Office of Chief Counsel
Internal Revenue Service
memorandum

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to: Associate Area Counsel (LMSB) Area 3 - Nashville
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from: Associate Chief Counsel, Financial Institutions & Products, Branch 4

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subject: **Request for Field Service Advice**
Non-Docketed Large Case

Legend

Parent =

Taxpayer =

State X =

Year 1 =

Year 2 =

Year 3 =

Year 4 =

This responds to your January 14, 2002 memorandum requesting our advice regarding the proper calculation of the reduction for tax-exempt interest under section 832(b)(5)(B) of the Internal Revenue Code in arriving at Taxpayer’s deduction for losses incurred on insurance contracts during the taxable year, as provided by section 832(c)(4).

ISSUES

1. Is the amount of tax-exempt interest included in the reduction of the deduction for losses incurred as required by section 832(b)(5)(B) the gross amount of the tax-exempt interest or the amount of tax-exempt interest net of any amortizable bond premium attributable to the instruments paying the tax-exempt interest?

2. If the amount of tax-exempt interest properly taken into account in calculating the reduction of the deduction for losses incurred as required by I.R.C. section 832(b)(5)(B) is the amount of tax-exempt interest net of any amortizable bond premium, does Taxpayer's utilization of this amount in computing the reduction under section 832(b)(5)(B) for Year 1 and subsequent years constitute a change in method of accounting to which the provisions of section 446 apply?

3. Should Taxpayer be allowed to adjust the amount of tax-exempted interest used in calculating the section 832(b)(5)(B) reduction of the deduction for losses incurred based on the ratio of Taxpayer's loss reserves attributable to transactions with Parent, which do not constitute an insurance contracts for tax purposes?

ANSWERS

1. The amount of "tax-exempt interest" to be included in calculating the reduction of the deduction for losses incurred under section 832(b)(5)(B) should be tax-exempt interest net of any amortizable premium paid for the bond(s) generating the tax-exempt interest.

2. Taxpayer's utilization of tax-exempt interest, net of amortizable bond premium, in computing the reduction of the deduction for losses incurred under section 832(b)(5)(B) beginning with Year 1 does not constitute a change in method of accounting.

3. The administrative position of the Service is that a captive insurance subsidiary is treated as the owner of the assets transferred by its parent corporation, even if the parent's deduction for the related insurance premiums is disallowed because the arrangement does not constitute an insurance contract for tax purposes. Accordingly, the adjustment made by Taxpayer in calculating the amount of tax-exempt interest subject to the reduction under section 832(b)(5)(B) for the "portion attributable to Parent" should be disallowed.

DISCUSSION

Facts

Taxpayer is organized as a captive insurance company under the laws of State X. Taxpayer is a wholly owned subsidiary of Parent and joins with Parent and certain other operating subsidiaries of Parent (collectively, the Subsidiaries) in filing a consolidated federal income tax return on a calendar year basis. Taxpayer has filed its returns as an insurance company taxable under section 831(a). Taxpayer's principal business is to provide indemnification for losses sustained by Parent and Subsidiaries. For purposes of this memorandum, we have assumed that the contracts between Taxpayer and Subsidiaries are insurance contracts for tax purposes, whereas the contract between Taxpayer and Parent is not an insurance contract for which the premiums paid by Parent were deductible under section 162(a). See, e.g., Humana Inc. v. Commissioner, 881 F.2d 247 (6th 1989).

One source of income for Taxpayer is tax-exempt interest. We assume for purposes of this memorandum that the income from these bonds is fully tax-exempt under section 103. For some of these bonds, Taxpayer paid a premium, i.e., paid more than the face amount of the bond. In computing its insurance company taxable income, Taxpayer is required, under section 832(b)(5)(B), to reduce the deduction losses for incurred under section 832(c)(4) by 15 percent of, inter alia, the amount of tax-exempt interest received or accrued during the year.

On its original federal income tax returns for Year 1 and Year 2, Taxpayer computed the 15 percent reduction of its allowed losses incurred by reference to the gross amount of tax-exempt interest that it received or accrued during each year. However, Taxpayer now seeks to change the computation of the reduction of its allowed losses incurred. Taxpayer submits that the amount of tax-exempt interest implicated in the computation should be that net of amortizable bond premium. And on its original federal income tax returns for Year 3 and Year 4, Taxpayer has computed the reduction of its allowed losses in this manner.

In addition, for each year Taxpayer makes a modification to its computation under section 832(b)(5)(B) for a "portion attributable to Parent". Taxpayer's rationale for this adjustment is that it is consistent with the distinction drawn in Humana and certain other cases, in which the courts have found that an arrangement between a captive insurance subsidiary and its parent corporation does not constitute insurance, although insurance may exist between the captive and other affiliated corporations. Taxpayer calculates the adjustment to tax-exempt interest for the “portion attributable to Parent” by applying a fraction to the amount otherwise computed under section 832(b)(5)(B). The numerator of this fraction is an amount deemed “parent company reserves” and the denominator is the total reserves of Taxpayer. The fraction thus created is then applied to the section 832(b)(5)(B) reduction of the allowable losses incurred. The resulting product is then deemed the final section 832(b)(5)(B) reduction and is subtracted from the amount of losses incurred under § 832(c)(4) in arriving at Taxpayer’s taxable income. The effect of this adjustment is similar to treating Parent as the owner of a pro rata share of the securities producing the tax-exempt income.

Law and Analysis

Issue #1

Taxpayer is an insurance company other than a life insurance company. Section 831 imposes the tax provided in section 11 on the taxable income of such a company.

Section 832(a) of the Code defines the “taxable income” of a non-life insurance company as the “gross income” of the company less certain allowed deductions. Section 832(b) defines the “gross income” as the sum of certain items, including the gross amount of “underwriting income”. Section 832(b)(1)(A). Underwriting income, in turn, is defined as the “premiums earned on insurance contracts during the taxable year less losses incurred”. Section 832(b)(3). Section 832(b)(5)(A) defines “losses incurred” as, inter alia, “losses paid during the taxable year”.

However, section 832(b)(5)(B) imposes a limitation on the amount of “losses incurred”. The amount of losses to be deducted from premiums earned is reduced by 15% of, inter alia, “tax-exempt interest received or accrued during such taxable year”. Section 832(b)(5)(B)(i).

Neither the Code nor the applicable regulations specifically define “tax-exempt interest” for purposes of section 832(b)(5)(B)(i). The question therefore posed is whether “tax-exempt interest” for purposes of section 832(b)(5)(B)(i) is simply the gross amount of interest received or accrued during the year that is exempt from tax, or whether it is the amount received or accrued during the year net of the amortization of any premium paid for the instrument(s).

As the House Committee pointed out during consideration of section 832, “[t]he deduction for losses incurred reflects losses paid during the year as well as the increase in reserves for losses incurred but not paid." H.R. Rep. No. 426, 99th Cong. 1st Sess. 670 (1985). To the extent a non-life insurance company was able to fund losses incurred with income exempt from tax, that company would obtain a double tax benefit by deducting losses which were paid with income that had not been taxed. In enacting section 832, Congress was of the mind that "it is not appropriate to fund loss reserves on a fully deductible basis out of income which may be, in whole or in part, exempt from tax." Id. See also, General Explanation of the Tax Reform Act of 1986, Staff of Joint Committee on Taxation, 100th Cong., 1st Sess. 598 (1987). In order to accomplish this, Congress intended that

> [t]he amount of the addition to reserves that is deductible should be reduced by a portion of such tax-exempt income to reflect the fact that reserves are generally funded in part from tax-exempt interest...Therefore, the bill includes a proration provision.

H.R. Rep. No. 426, at 670.

Congress drew a parallel to the treatment of life insurance companies, taxable under section 801. Life insurance companies are required to reduce their increase in reserves by, inter alia, "the amount of the policyholder's share of tax-exempt interest". Section 807(b)(1)(A). As the General Explanation points out, for non-life insurance companies,

> [n]o reduction in the loss reserve deduction was required, under prior law, to take account of the fact that deductible additions to reserves could come out of income not subject to tax. Unlike life insurance companies, property and casualty insurance companies were not required to allocate or prorate investment income (including tax-exempt investment income) so as to take account of the possibility of a double deduction where deductible additions to reserves were funded with tax-exempt income".

General Explanation at 598.

In order to address this double benefit, and to provide a proration rule for non-life insurance companies similar to the life insurance company tax rule, Congress utilized a proxy approach by requiring that the amount of losses incurred deductible by a non-life insurance company to be "reduced by a specified portion of the insurer's tax-exempt interest." H.R. Rep. No. 841, 99th Cong., 2d Sess., (1986) II-356-57. By requiring the deduction to be reduced by a "specified portion" less than 100%, Congress affirmatively allowed non-life insurance companies to obtain a degree of a double benefit from being able to deduct losses incurred which were paid with income exempt from tax.

Neither section 832 nor the regulations thereunder define what constitutes "tax-exempt interest received or accrued during such taxable year". The Conference Committee Report indicates that "[f]or this purpose, tax-exempt interest includes interest income excludable under section 103 (or deductible under section 832(c)(7)), the portion of interest income excludable under section 133[1], and other similar items."

Section 832(c)(7) provides merely that "the amount of interest earned during the taxable year which under section 103 is excluded from gross income" is deductible; section 1.832-5 does not elaborate on this item.

Section 103 provides that, subject to certain exceptions, "gross income does not include interest on any State or local bond." Section 103(a). Where a premium is paid for a tax-exempt bond, the premium must be amortized. Section 1.171-1(c)(1), Income Tax Regulations. While the premium so amortized cannot be deducted from gross income, section 171(a)(2), it does reduce the taxpayer's basis in the bond. Section 1016(a)(5). Moreover, the amortizable premium serves to reduce the amount of tax-exempt interest income. Section 1.171-2(c) ex. 4, Income Tax Regulations.

It is noteworthy that life insurance companies, the treatment of which section 832(b)(5)(B) is intended to parallel, compute items net of amortizable premiums. Section 811(b). And of perhaps greater significance, in computing section 832(b)(1)(A) gross investment income, section 834 requires that a non-life insurance company include "[t]he amount of interest which under section 103 is excluded for the taxable year from gross income." This provision, whose language is similar to that in section 832(b)(5)(B)(i), has been interpreted to be net of amortizable premium. Section 1.822-10(a), Income Tax Regulations.

Finally, we think that including amortizable bond premium in the computation under section 832(b)(5)(B) provides a clear reflection of the economic effect. Perhaps this can best be illustrated by example. Assume a non-life insurance company purchases a bond that generates tax-exempt interest of $100 per

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[1] Section 133 has since been repealed.

year. Assume further that this bond was purchased at a premium and that for the year in question the amortizable portion of the premium is $10. Finally, assume that the company uses the $100 tax-exempt interest to fund losses. Because bond premium can be thought of as a return of the company's investment, the company effectively only funded losses to the extent of $90 from the interest on the bond. The excess of the $100 of tax-exempt interest received or accrued during the year, over the amount of tax-exempt interest adjusted by the amortizable bond premium, is treated as a recovery of Taxpayer's basis in the underlying security. Accordingly, to allow a non-life insurance company to compute the reduction of the deduction for losses incurred as required by section 832(b)(5)(B) by determining tax-exempt interest to be net of the bond premium amortizable thereto seems to us to be appropriate.

Issue #2

You ask if Taxpayer's switch to computing tax-exempt interest net of amortizable bond premium constitutes a change in method of accounting. If so, then Taxpayer must secure the consent of the Commissioner prior to doing so.

Treas. Reg. section 1.446-1(a)(1) defines the term "method of accounting" to include both the overall method of accounting and the accounting treatment of any item.

In an effort to clarify what constitutes a change in method of accounting, T.D. 7073, 1970-2 C.B. 98, amended Treas. Reg. section 1.446-1(e)(2)(ii), regarding the requirements for adopting or changing accounting methods. Treas. Reg. section 1.446-1(e)(2)(ii)(a), as amended, provides in part that a change in method of accounting includes a change in the overall plan of accounting for gross income or deductions or a change in the treatment of any "material item" used in the overall plan. Although a method of accounting may exist without the necessity of a pattern of consistent treatment of an item, in most instances a method of accounting is not established for an item without consistent treatment. A material item is any item which involves the proper time for the inclusion of an item in income or the taking of a deduction.

Conversely, Treas. Reg. section 1.446-1(e)(2)(ii)(b) provides that an adjustment of any item of income or deduction not involving the proper timing of an item's inclusion or deduction is not a change in method of accounting. Further, "[a] change in method of accounting does not include correction of...errors in the computation of tax liability."

Initially in question is whether the Taxpayer's initial computation of not accounting for amortizable bond premium when computing its tax-exempt interest under I.R.C. section 832(b)(5)(B) is a method of accounting. If it is not, then Taxpayer does not have an accounting method that could have been changed.

To be an accounting method, Taxpayer's initial computation of not accounting for amortizable bond premium in computing its I.R.C. section 832(b)(5)(B) tax-exempt interest must involve the accounting treatment of an item. Treas. Reg. section 1.446-1(a)(1). An item is any recurring element of income or expense. For example, an insurance dividend is an item. Commissioner v. O. Liquidating Corp., 292 F.2d 225 (3rd Cir. 1961), cert. denied, 368 U.S. 898 (1961). We understand that Taxpayer is computing an income amount (i.e., underwriting income) and thus its computation does involve the treatment of an item.

Additionally, for Taxpayer's initial computation of not accounting for amortizable bond premium in computing its I.R.C. section 832(b)(5)(B) tax-exempt interest to be an accounting method, it must have been consistently used. Treas. Reg. section 1.446-1(e)(2)(ii)(a). Contra, Rev. Rul. 90-38, 1990-1 C.B. 57 (consistent treatment is not required to adopt a method of accounting when an item is treated properly on the first tax return that reflects the item).

Taxpayer used its initial computation for at least two years. Thus, even though this computation was contrary to the the appropriate computation under I.R.C. section 832(b)(5)(B), Taxpayer satisfies the consistent use standard of Treas. Reg. section 1.446-1(e)(2)(ii)(a).

Lastly, for Taxpayer's initial computation to qualify as a method of accounting, the computation must involve the treatment of a material item. Treas. Reg. section 1.446-1(e)(2)(ii)(a). Taxpayer's initial practice of not accounting for amortizable bond premium in computing its I.R.C. section 832(b)(5)(B) tax-exempt interest does not involve the treatment of a material item because it does not involve the proper time for the inclusion of the underwriting income in gross income.

I.R.C. section 832 requires Taxpayer to compute underwriting income by a mathematical formula. Taxpayer made an error in using this formula. It consistently, but incorrectly, failed to account for its amortizable bond premium in computing its tax-exempt interest for purposes of I.R.C. section 832(b)(5)(B). This error will result in a cumulative amount of lifetime taxable income being recognized by Taxpayer which is greater than the amount of taxable income which would have been determined if Taxpayer had always included amortizable bond premium in the computation of tax-exempt interest subject to the 15 percent reduction of section 832(b)(5)(B). The effect is that Taxpayer previously used a formula that resulted in lesser deductions for losses incurred under section 832(c)(4), and those higher taxable income under section 832 for each of the taxable years in which the amortization of premium was excluded from the computation of tax-exempt interest. This error was not corrected when Taxpayer began to account for its amortizable bond premium; this only resulted in Taxpayer using the correct formula to determine the reduction for tax-exempt interest as required by section 832(b)(5)(B) for the year(s) involved. Thus the correction of Taxpayer’s mistake is a correction of an error, not a change in accounting method.

Issue #3

In computing the reduction of the amount of its allowed losses incurred under section 832(b)(5)(B), Taxpayer adjusts the amount of tax-exempt interest received or accrued during the taxable year, net of amortizable bond premium, by a “portion attributable to Parent”. This “portion” is the result of prorating the amount of tax-exempt interest subject to the 15 percent reduction under section 832(b)(5)(B) between an amount attributable to Taxpayer’s deductible loss reserves and an attributable to losses reserves attributable to transactions with Parent, which do not constitute insurance contracts for tax purposes and therefore are excluded from Taxpayer’s deduction for losses incurred under section 832(c)(4). The fraction is essentially the ratio of what Taxpayer deems to be Parent’s share of the tax-exempt interest. The effect of this adjustment is to treat Parent as the owner of a pro-rata share of the underlying securities generating the tax-exempt income. Taxpayer claims this adjustment is consistent with the holding of Humana and other court decisions that the arrangement under which it indemnified Parent’s losses does not constitute an insurance contract for tax purposes, and therefore must be excluded from the calculation of Taxpayer’s deductible losses incurred under section 832(c)(4).

It is our position that the characterization of Taxpayer’s arrangement with Parent as other than an insurance contract for tax purposes is not relevant to the determination of Taxpayer’s adjustment for tax-exempt interest under section 832(b)(5)(B), and that so long as Taxpayer qualifies as an insurance company under section 831 on the basis of its overall activities, Taxpayer is required by section 832(b)(5)(B) to reduce its deduction for losses incurred by 15 percent of the amount of tax-exempt interest received or accrued during the taxable year.

In Rev. Rul. 77-316, 1977-2 C.B. 53, the Service noted that the payment of funds from a parent to its captive subsidiary is merely the movement of an asset from the parent to the subsidiary. Because the captive insurance subsidiary is an independent corporate entity, it is the owner of the funds transferred by the parent corporation. In this regard, Rev. Rul. 77-316 states that when a parent transfers funds to its captives follows:

> Amounts paid as so-called insurance premiums by X. Y, and Z, and their domestic subsidiaries, with respect to risks remaining with S1, S2, and S3, respectively, will not constitute taxable income to S1, S2, and S3 under section 61 of the Code as nothing has occurred other than a movement of an asset (cash) within each family or related corporations. Instead such amounts will be considered contributions of capital under section 118.

In Rev. Rul. 2001-31, the Service indicated that in analyzing the tax consequences of a captive insurance arrangement, it would no longer rely on the "economic family theory" set forth in Rev. Rul. 77-316. Accordingly, Rev. Rul. 77-316 is obsoleted insofar as it relied on a theory that there can be no risk shifting or risk distribution within an economic family of corporations. Rev. Rul. 2001-31 explains that the Service will no longer assert the economic family theory as the basis to disregard a captive insurance arrangement because the courts have failed to adopt this theory even in situations where they have agreed that the parent's deduction of the so-called insurance premiums should be disallowed. Accordingly, because Rev. Rul. 2001-31 did not modify the Service's administrative position with respect to ownership of funds transferred to a captive insurance subsidiary, the modification made by Taxpayer in computing the amount of tax-exempt interest subject to the section 832(b)(5)(B) reduction with respect to the "portion attributable to Parent" should be disallowed.

Case Development, Hazards, and Other Considerations

Inasmuch as we agree with the Taxpayer, no hazards are presented with respect to our conclusion on Issue #1.

With respect to our conclusion with respect to Issue #3, the government faces the hazard that a court will determine that this adjustment either individually or in concert with other adjustments does adequately implement the Humana decision. Cf., Johnson v. Commissioner, 184 F.3d 786, 789 (8th Cir. 1999) ("The escrowed amounts are held for the benefit of the taxpayers, either for payment directly to them or for the discharge of their obligations...Money earned by these amounts should follow the same path for tax purposes.") [redacted]

/S/

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