INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM
April 16, 2003

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CASE MIS No.: TAM-168118-02/CC:FI&P:BO4

Team Manager
LMSB Financial Services
LMSB:CTM:1362

Taxpayer's Name:

Taxpayer's Address:

Taxpayer's Identification No:
Years Involved:
Date of Conference:

LEGEND:

Taxpayer =

Holding =

Parent =

Amount 1 =

Amount 2 =

Amount 3 =

Amount 4 =

ISSUE(S):

Whether, under the facts described, certain expenses incurred by Taxpayer in order to diversify its offerings of life insurance and annuity products, and to expand its distribution channels, constitute capital expenditures under § 263(a) of the Internal Revenue Code.

CONCLUSION:

The expenses incurred by Taxpayer to diversify its offerings of life insurance and annuity products, and to expand its distribution channels, are deductible as ordinary and necessary business expenses under § 162(a), and, therefore, are not treated as capital expenditures under § 263(a). Pursuant to § 848(a), however, Taxpayer is required to capitalize and to amortize as "specified policy acquisition expenses" an amount of otherwise deductible expenses equal to a percentage of the net premiums attributable for certain categories of life insurance, annuity, and guaranteed renewable accident contracts.

FACTS:

Taxpayer is a life insurance company within the meaning fo § 816(a) and is the principal subsidiary of Holding, an insurance holding company, which in turn is a subsidiary of Parent, a diversified financial services company. During the taxable years involved, Taxpayer joined with other eligible life insurance companies and non-insurance members of Parent's consolidated group in filing a life/nonlife consolidated return pursuant to § 1504(c) and § 1.1502-76 of the Income Tax Regulations.

Through Taxpayer and other insurance company subsidiaries, Parent's consolidated group markets a diverse array of insurance products, including individual and group life insurance, fixed and variable annuities, multiple lines of property and casualty insurance, and supplemental health insurance. As the lead life insurance company within Parent's consolidated group, Taxpayer historically concentrated on the sale of § 403(b) tax deferred fixed annuities to employees of not-for-profit institutions, primarily teachers. These products account for a significant portion of Taxpayer's existing policy reserves. During recent years, the low interest rate environment and strong equity market returns affected the demand for Taxpayer's tax deferred fixed annuity products and led to increased surrenders of existing contracts. To counteract these trends, Taxpayer embarked on a business strategy of expanding its product portfolio through the introduction of variable and equity-indexed annuities, and new plans of life insurance and supplemental health products. Taxpayer also sought to expand its network of independent agents in order to increase sales of life insurance and annuity products beyond the qualified pension market. The impact of this business strategy is evidenced by the fact that during the taxable years involved, the percentage of Taxpayer's annuity premiums attributable to § 403(b) tax deferred fixed annuities fell from Amount 1% to Amount 2%, while the percentage of Taxpayer's total premiums from life insurance, annuity, and supplemental health insurance policies sold in the non-qualified market grew from Amount 3% to Amount 4%.

The expenses at issue in this technical advice include certain expenses incurred by Taxpayer relating to the introduction of new insurance and annuity products, and to the expansion of Taxpayer's network of independent insurance agents for the purpose of increasing the sales of Taxpayer's insurance and annuity products beyond the educational market. The expenses at issue fall into the following broad categories: general overhead, actuarial services, legal and professional fees, computer expenses, promotional expenses, and educational and training expenses.[1] On Parent's consolidated financial statements prepared using generally accepted accounting principles, these expenses were capitalized and amortized over a five year period, in accordance with Statement of Position 98-5, "Reporting the Costs of Start-up Activities". For both annual statement and tax reporting purposes, however, Taxpayer treated the expenses as currently deductible business expenses.

The examining agent found that the expenses at issue were incurred to create or enhance long-lived intangible assets which would produce significant future benefits to Taxpayer. Accordingly, the agent concluded that the expenses are capital expenditures under § 263(a), which are "recovered through depreciation, amortization, cost of goods sold, as an adjustment to basis, or otherwise." See § 1.263(a)-2(a); INDOPCO, Inc. v. Commissioner, 503 U.S. 79 (1992). The examining agent also argues that the treatment of these expenses as capital expenditures under § 263(a) is not inconsistent with § 848, since the amounts capitalized as specified policy acquisition expenses under § 848 are drawn from the insurance company's "general deductions," and thus do not include capital expenditures.

Taxpayer maintains that the expenses at issue are part of the regular and recurring expenses incurred in the operation of an on-going insurance business, and thus constitute ordinary and necessary business expenses under § 162(a). Taxpayer also argues that the examining agent's treatment of these expenses as capital expenditures under § 263(a) would be inconsistent with the Congressional intent underlying § 848.

LAW AND ANALYSIS:

Section 161 allows a deduction for the items specified in part VI of subchapter B of chapter 1 of the Code (i.e., sections 161-198), subject to the exceptions provided in part IX, section 261 et seq.

Section 162(a) allows a deduction for all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on a trade or business.

Section 261 provides that no current deduction shall be allowed in respect of the items specified in part IX (i.e., sections 261-280H).

[1]The expenses at issue do not include any employee compensation or de minimis costs paid by Taxpayer for which it is the Service's policy to not assert capitalization.

Section 263(a) provides that no current deduction shall be allowed for any amount paid for permanent improvements or betterments made to increase the value of any property.

Section 801(b) defines life insurance company taxable income as life insurance gross income, reduced by life insurance company deductions. Under § 804, life insurance company deductions are composed of (1) the general deductions provided by § 805 plus (2) the small life insurance company deduction, if any, under § 806.

Section 805(a)(8) authorizes the deduction of the items allowed under subtitle A for purposes of computing taxable income. Accordingly, § 805(a)(8) incorporates the deduction for "ordinary and necessary expenses" under § 162(a), but does not authorize the deduction of capital expenditures described in § 263(a).

Section 811(a) provides that for purposes of computing life insurance company taxable income, all computations shall be made (1) under an accrual method of accounting, or (2) under a combination of the accrual method of accounting and any other method specifically permitted under regulations prescribed by the Secretary. To the extent not inconsistent with the foregoing, all such computations shall be made consistent with the manner required for purposes of the annual statement.

Section 848 provides that an insurance company must capitalize and amortize its "specified policy acquisition expenses" for the taxable year ratably over a period of 120 months, beginning with the first month of the second half of the taxable year in which these expenses are incurred. In lieu of identifying specific categories of policy acquisition expenses to be capitalized, § 848 requires the insurance company to determine the amounts capitalized as specified policy acquisition expenses based on a percentage of the net premiums for certain broad categories of business ("specified insurance contracts"). Under § 848(c)(2), the amounts amortized as specified policy acquisition expenses are subtracted from the insurance company's "general deductions" for the taxable year, which includes the deductions provided in part VI of subchapter B, §§ 161 -198, and in part I of subchapter D (§ 401 et. seq., relating to pension, profit sharing, stock bonus plans, etc.). Thus, the definition of general deductions excludes capital expenditures under § 263(a), although the amounts recovered during the taxable year through amortization or depreciation of these expenditures are included in "general deductions." Specified insurance contracts are defined by § 848(e)(1) as any "life insurance, annuity, or noncancellable accident and health insurance contract" other than any pension plan contract, flight insurance or similar contract, or qualified foreign contract.

The provisions of Part I of subchapter L of the Code were substantially revised by the Tax Reform Act of 1984 ("1984 Act"), P.L. 98-369, 98 Stat. 494, 720 (1984). According to the legislative committee reports, where the 1984 Act carried over a provision from prior law, Congress generally intended the new provision to be interpreted consistent with prior law. Thus, in the absence of contrary guidance in the legislative committee reports, the regulations, rulings, and case law may serve as interpretative guides to the new provisions. See H.R. Rep. No. 432, 98th Cong. 2d Sess., Pt. 2, 1401 (1984); S. Prt. No. 169 Vol. 1, 98th Cong., 2d Sess. 524 (1984).

Section 805(a)(8) is the successor provision to prior § 809(d)(11)[2] enacted as part of the Life Insurance Company Tax Act of 1959 ("1959 Act"), P.L. 86-69, 73 Stat. 112 (1959). Under the 1959 Act, it was generally recognized that agents' commissions and other initial selling expenses incurred by direct insurers would be currently deductible in the year incurred under prior § 809(d)(11). This treatment of policy acquisition expenses is indicated in the legislative committee reports of the 1959 Act in explaining how the inclusion of underwriting gains and losses would affect the tax base of life insurance companies:

> Although for many companies taking underwriting gains or losses into account means a larger tax base, growing life insurance companies, having underwriting losses rather than gains, the inclusion of this underwriting element in the tax base means a lesser, rather than greater tax. The small, new, and growing life insurance companies are particularly likely to have underwriting losses because of the initial costs which they incur (such as agents' commissions) in placing new policies on their books. Both the House and your committee's bill are particularly liberal in these cases since they allow the offset of these underwriting losses in full against taxable investment income (subject to certain restrictions as to the deduction of policyholder dividends, etc.) and do not require the 50 percent reduction in such losses which would be made if they were gains.

S. Rep. No. 291, 86th Cong., 1st Sess. 7 (1959), 1959-2 C.B. 770, 775; see also H.R. Rep. No. 34, 86th Cong., 1 Sess. 4 (1959), 1959-2 C.B. 736, 738.

Section 805(a)(8), like its predecessor § 809(d)(11), incorporates the deduction for ordinary and necessary business expenses under § 162(a). The scope of the deductions considered ordinary and necessary within the meaning of § 162 as applied to a life insurance company's expenses incurred in developing a new insurance product was considered by the Tax Court in Equitable Life Ins. Co. of Iowa v. Commissioner, T.C. Memo. 1977-299. In Equitable, the court allowed as a deduction for ordinary and necessary expenses the costs incurred to register a variable annuity

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[2]This paragraph was originally numbered § 809(d)(12) and was redesignated § 809(d)(11) by the Tax Reform Act of 1976, P.L. 94-455, § 1901(a)(98)(B)(i), 90 Stat. 1520, 1781 (1976).

contract with the United States Securities and Exchange Commission. The court found that "[t]he variable annuity contract is simply another product in the insurance business and the expense of placing it on the market is part of the day-to-day expense (here a selling expense) of producing and marketing a business product." The registration process was "required for each new or modified annuity contract marketed by any particular insurance company" and as such was "not a once-in-a-lifetime expenditure for similarly situated insurance companies" nor was it "like the acquisition of a license to commence operation of a business." Rather, these costs were "normal, usual, and customary in the day-to-day operations of the insurance business" hence deductible.

This historical treatment of agents' commissions and other initial selling expenses of direct insurers as currently deductible expenses under § 162(a), rather than capital expenditures under § 263, was also recognized by the United States Supreme Court in Colonial American Life Ins. Co. v. Commissioner, 491. U.S. 244 (1989), 1989-2 C.B. 110. Although the Colonial American case involved the tax treatment of ceding commissions on indemnity reinsurance, rather than agents' commissions and other selling expenses of direct insurers, the Supreme Court described this issue as a battle of analogies - i.e., whether the ceding commissions were analogous to agents' commissions and other expenses incurred in directly written insurance, which were currently deductible, or whether the ceding commissions were analogous to the commissions paid by assumption reinsurers to acquire in force business of other companies, which were capitalized and amortized over the life of the acquired policies. In this regard, the Supreme Court observed that although the provisions of Part I of subchapter L did not provide explicit authority for a life insurance company to deduct agents' commissions and other selling expenses in the year of payment, the legislative committee reports for both the 1959 Act and the 1984 Act show that Congress recognized and approved this practice. See 491 U.S. at 249-50, n4, 1989-2 C.B. at 114, n4.

In the 1984 Act, Congress substantially modified the general accounting provisions for life insurance companies, to emphasize the primacy of Federal tax accrual rules and other accounting rules set forth in Part of subchapter L over the accounting treatment allowed in preparing the life insurance company's annual statement for State regulatory reporting purposes. Section 811(a), which prescribes the general method of accounting to be used by a life insurance company, maintains the same general requirement as former § 818(a) that life insurance companies must use an accrual method, or a method permitted under the regulations that combines an accrual method with another recognized method. However, § 811(a) makes clear that accounting methods required for State regulatory purposes apply only to the extent that they are not inconsistent with Federal tax accounting rules. In explaining this new emphasis in § 811(a) on Federal tax accounting rules, however, the legislative committee reports emphasize that this change was not intended to change the historical practice of direct insurers regarding the current deductibility of agents' commissions and other selling expenses:

> [T]he bill makes clear that accounting methods required for State regulatory purposes apply only to the extent that they are not inconsistent with Federal tax accounting rules. The change from present law was intended to reinforce the primacy of the Federal tax rules and not impose a new method of tax accounting on life insurance companies. Thus, for example, agents' commissions paid by direct insurers would continue to be treated as sales expenses and deductible when paid, as has been allowed historically (even though they arguably might be classified as acquisition expenses to be amortized).

H.R. Rep. No. 423, at 1428; S. Prt. No. 169, Vol. 1, at 555.

In the Revenue Reconciliation Act of 1990, Pub. L. No. 101-508, 104 Stat. 1388-400, 1388-445, Congress enacted § 848, which provides that insurance companies must capitalize and amortize "specified policy acquisition expenses." The 1990 Act legislative committee reports indicate that Congress believed the existing treatment of policy acquisition expenses resulted in a mismeasurement of income. According to the House report, this mismeasurement occurred because

> [p]olicy acquisition expenses arise in connection with acquiring a stream of premium and investment income that is earned over a period well beyond the year the expenses are incurred. It is a well-established principle of the tax law that costs of acquiring an asset with a useful life beyond the taxable year are capitalized and amortized over the life of the asset.

Ways and Means Cmte. Print No. 101-37, at 26-27 (1990).

The legislative committee reports also reveal that Congress was concerned that policy acquisition expenses of insurance companies were treated inconsistently depending on the context in which they were incurred. For example, in the case of a life insurance company which wrote business directly, first-year commissions and other selling expenses year were treated as fully deductible for the year incurred for purposes of computing the company's regular income tax. However, in the case of certain reinsurance transactions, the ceding commission paid by the reinsuring company was treated as the payment for an income-producing asset, and thus was required to be amortized over the life of the asset. Finally, for purposes of the adjusted current earnings provision of the corporate minimum tax, life insurance companies were required to amortize their premium acquisition expenses consistent with the treatment provided under generally accepted accounting principles. Ways and Means Cmte. Print No. 101-37 at 25-26.

In order to address these concerns, Congress enacted § 848, which requires insurance companies to capitalize and amortize their "specified policy acquisition expenses" on a straight-line basis over a period of 120 months, beginning with the first month in the second half of the taxable year in which the expense are incurred. The amortizable amounts under § 848 are determined based on certain stated percentages of the insurance company's net premiums for the taxable year from new and renewal insurance policies in certain broad categories of business. According to the legislative committee reports, this proxy approach was chosen to provide an administratively practicable system at the potential detriment of having a less than economically precise system for measuring income. That is, a system which would have required an insurance company to separately identify its policy acquisition expenses, and determine an appropriate amortization method for these expenses would cause difficult administrative and enforcement problems because it would be extremely difficult to provide clear rules for such a method without the method being inordinately complex and imposing costly recordkeeping burdens. Ways and Means Cmte. Print No. 101-37, at 27-28.

In enacting § 848, Congress generally did not intend this amortization requirement to change the characterization of an insurance company's expenses incurred in the taxable year as either ordinary and necessary business expenses under § 162(a) or capital expenditures under § 263(a).[3] Therefore, we agree with the examining agent that if an insurance company were required to treat a type of expense as a capital expenditure under § 263(a) prior to the enactment of § 848, the addition of this amortization requirement does not change the tax character of the expense.

On the other hand, the legislative committee reports underlying § 848 indicate that Congress understood that under the existing provisions of Part I of subchapter L, a life insurance company was allowed to treat agents' commissions and other selling expenses incurred with respect to the sale of new and renewal insurance policies as currently deductible business expenses under § 162(a), rather than treat these expenses as capital expenditures under § 263(a). Moreover, these legislative committee reports indicate that, like § 263(a) and other capitalization requirements in the Code, Congress intended this amortization requirement to result in a better measurement of the company's income on a periodic basis, by ensuring that the company's deduction for these specified policy acquisition expenses more closely matched the future earnings stream from the related insurance policies.

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[3] An exception to this rule is § 848(g), which provides that nothing in any provision of law (except for §§ 197 and 848) shall require the capitalization of any ceding commission under any reinsurance agreement that reinsures a specified insurance contract. As originally enacted in the 1990 Act, this provision repealed the requirement in section 1.817-4(d) and the Colonial American case that reinsurers amortize ceding commissions in certain reinsurance agreements covering specified insurance contracts.

Accordingly, we believe that most of the expenses at issue do not appear to be of the kind of expenses which an insurance company had to capitalize prior to the enactment of § 848. See Equitable, T.C. Memo. 1977-299. Moreover, applying the future benefits analysis to these expenses is inconsistent with the intent underlying § 848, even though a taxpayer in another industry might be required to capitalize similar expenses.[4] Requiring a fact-specific inquiry to isolate certain expenses attributable to certain "start-up" activities relating to Taxpayer's introduction of new insurance products, or to the expansion of Taxpayer's distribution network, from other deductions claimed with respect to the acquisition of new and renewal insurance policies would contradict the Congressional decision to base the determination of an insurance company's amortizable policy acquisition expenses on a proxy approach. This would create the uncertainty and administrative complexity Congress wanted to avoid.

CAVEAT(S)

A copy of this technical advice memorandum is to be given to the taxpayer(s). Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

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[4] We assume that the expenses included in the examining agent's schedule of "start-up activities" do not include expenses that would be subject to recovery through depreciation or amortization except for their purported relationship to the creation or enhancement of intangible assets that will produce significant future benefits to Taxpayer. Thus, for example, if the computer expenses include certain costs that are recoverable through depreciation or amortization irrespective of these intangible benefits, our conclusion would not affect the treatment of these expenses.