Internal Revenue Service

Number: **201724012**
Release Date: 6/16/2017
Index Number: 162.00-00

Department of the Treasury
Washington, DC 20224

Third Party Communication: None
Date of Communication: Not Applicable

Person To Contact:
, ID No.
Telephone Number:

Refer Reply To:
CC:ITA:B02
PLR-128539-16
Date:
March 13, 2017

TY:

Legend

Association =
State =
State Fund =

Payment =
Reserve =

Statute 1 =

Statute 2 =
Statute 3 =
Statute 4 =
Year 1 =
Year 2 =
Year 3 =
Year 4 =
Year 5 =
Year 6 =
Date 1 =
Fund 1 =
Fund 2 =
X =
Y =
Z =

Dear :

This responds to a letter dated September 13, 2016, submitted on behalf of Association requesting rulings concerning the Payment by Association to the State Fund.

RULINGS REQUESTED

(1) Whether the Payment by Association to the State Fund is deductible as an ordinary and necessary business expense under § 162(a) of the Internal Revenue Code.

(2) Whether the Payment by Association to the State Fund is not capitalized under § 263(a).

FACTS

Taxpayer represents that the facts are as follows:

Association is a non-stock insurance company created by State Statute 1 enacted in Year 1, in response to the need for additional medical malpractice insurance providers in State. Under State Statute 2, with minor exceptions, every insurer authorized to write liability insurance on a direct basis within State is required to be a member of Association. Association writes medical malpractice insurance for medical service providers and nursing homes in State. The issuance of these insurance contracts is the only business of Association. Association is regulated by the State Department of Insurance. Association is not owned by State and is not a part of State. Association is a taxable insurance company. Since Year 4, Association has each year reported taxable income pursuant to § 832.

As directed by Statute 3, Association's after-tax operating profits (except those attributable to insurance issued to nursing homes and assisted living facilities) are added to its surplus Reserve.

Fund 1 was initiated in Year 2 with each policyholder annually paying into Fund 1 an amount that was proportionate to each premium payment for liability insurance purchased through Association as determined by an advisory committee to Association. Contributions to Fund 1 have not been made since Year 3 as the Fund 1 balance has been deemed to provide sufficient cushion against adverse experience. Fund 1 is not property of State.

Any operating deficit sustained by Association is recouped by a contribution from Fund 1 until it is exhausted and next, if necessary, by an assessment on the policyholders and then on the members of Association.

During Year 5, the state legislature created a separate fund (Fund 2) for operating profits from policies sold to nursing homes and assisted living facilities. Fund 2 operates similar to Fund 1, but unlike Fund 1, Fund 2 is property of State. Amounts paid to the State Fund from Fund 2 will not be deducted on Association's Year 6 federal income tax return and are not included in this private letter ruling request.

In Year 6, after determining there was a critical shortage of medical residents serving the state, the State legislature enacted Statute 4 creating the State Fund to help support graduate medical education. The sums in the State Fund are to be used to support grants to hospitals and medical schools, inter alia, to provide graduate medical education programs and create first-year residency positions. Under Statute 4, Association's Reserve, Fund 1, and Fund 2 are the primary funding sources for the State Fund. As required by the legislation, on Date 1, Association paid $X to the State Fund. Of this amount $Y was distributed from Fund 2 and is therefore not subject to this private letter ruling request. Thus, Payment is $Z.

Improving the quality and accessibility of graduate medical programs in State provides an economic benefit to the industry of medical practitioners and is expected to increase the number of licensed medical professionals (potential customers of Association) within State. Association expects that a better educated industry of medical professionals will be less susceptible to medical malpractice claims. Since Association's only business is the issuance of insurance policies to medical professionals, the Payment to the State Fund has a direct relationship to the industry in which Association operates. Notably, the Payment is made with an expectation of financial return as the support for graduate medical education will increase gross premium revenue and improve the underwriting profit margins of Association. Also, Association can currently sell new policies and renew current policies, though under Statute 4, the ability to sell new policies in the future may be limited by State Department of Insurance.

LAW AND ANALYSIS

Ruling Request 1:

Section 162(a) provides, generally, that taxpayers may deduct all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business. *See also* § 1.162-1(a) of the Income Tax Regulations. In order to be deductible under § 162, an expenditure must be (1) paid or incurred during the taxable year, (2) related to carrying on a trade or business, and (3) ordinary and necessary for the trade or business. *Commissioner v. Lincoln Savings and Loan Ass'n*, 403 U.S. 345, 352, 91 S. Ct. 1893, 29 L. Ed. 2d 519 (1971).

The term "ordinary" refers to an expenditure that is normal, usual, or customary. *Deputy v. du Pont*, 308 U.S. 488, 495, 60 S. Ct. 363, 84 L. Ed. 416, 1940-1 C.B. 118 (1940). An expenditure may be ordinary if it is commonly and frequently incurred in the type of business involved. Id. (citing *Welch v. Helvering*, 290 U.S. 111, 114, 54 S. Ct. 8, 78 L. Ed. 212, 1933-2 C.B. 112 (1933)).

The term "necessary" means appropriate and helpful to the development of the taxpayer's business. *Commissioner v. Tellier*, 383 U.S. 687, 689, 86 S. Ct. 1118, 16 L. Ed. 2d 185 (1966) (quoting *Welch*, 290 U.S. at 113); *Commissioner v. Heininger*, 320 U.S. 467, 471, 64 S. Ct. 249, 88 L. Ed. 171, 1944 C.B. 484 (1943). A payment may be appropriate and helpful to the development of a taxpayer's business if that payment is mandated by a state governmental entity which confers upon the taxpayer the right to conduct its business in that state. See *Rothner v. Commissioner*, T.C. Memo. 1996-442.

In Rev. Rul. 95-32, 1995-16 I.R.B. 8, the Service ruled that payments by a public utility as part of programs to promote energy conservation and energy efficiency were business expenses that are deductible under § 162. These programs were aimed at reducing electrical costs to the taxpayer's customers, as well as addressing environmental and societal concerns with the adverse environmental effects of increased electrical generation. These programs also enabled the taxpayer to reduce its future operating and capital costs.

The Payment by Association to the State Fund is deductible as an ordinary and necessary business expense under § 162. The Payment is made with an expectation of financial return as the support for graduate medical education will increase gross premium revenue and improve the underwriting profit margins of Association. The Payment to State Fund is a requirement of the laws of State, and failure to make the Payment could jeopardize Association's continued business operations in State. The Payment is appropriate and helpful to Association's business, and therefore, the Payment is a necessary expense.

Accordingly, based solely upon the information submitted we conclude that Association's Payment to the State Fund is deductible as an expense under section 162(a).

Ruling Request 2:

Under § 161, if a cost is a capital expenditure, the capitalization rules of § 263 take precedence over the deduction rules of § 162. *Commissioner v. Idaho Power Co.*, 418 U.S. 1, 17, 94 S. Ct. 2757, 41 L. Ed. 2d 535 (1974). Therefore, a capital expenditure cannot be deducted under § 162, regardless of whether the expenditure is ordinary and necessary in carrying on a trade or business.

Section 263(a) generally prohibits deductions for capital expenditures. Section 1.263(a)-4 of the Income Tax Regulations provides rules for applying § 263(a) to amounts paid to acquire or create intangibles.

Section 1.263(a)-4(b)(1) provides that a taxpayer must capitalize: (i) an amount paid to acquire an intangible, (ii) an amount paid to create an intangible, (iii) an amount paid to create or enhance a separate and distinct intangible asset, (iv) an amount paid to create or enhance a future benefit identified in the Federal Register or in the Internal Revenue Bulletin as an intangible for which capitalization is required under this section, or (v) an amount paid to facilitate the acquisition or creation of an intangible, whether the taxpayer is the acquirer or the target.

Section 1.263(a)-4(b)(3)(i) provides that the term separate and distinct intangible asset means a property interest of ascertainable and measurable value in money's worth that is subject to protection under applicable State, Federal or foreign law and the possession and control of which is intrinsically capable of being sold, transferred or pledged (ignoring any restrictions imposed on assignability) separate and apart from a trade or business. The Payment is not an amount paid to create or enhance a separate and distinct intangible asset within the meaning of § 1.263(a)-4(b)(3).

Section 1.263(a)-4(b)(1)(i) provides that, in general, a taxpayer must capitalize amounts paid to acquire an intangible as provided in § 1.263(a)-4(c). Association made the Payment because State required that Association to make it. Association did not acquire or purchase an intangible when it made the Payment. As a result, the Payment does not constitute an amount paid to acquire an intangible within the meaning of § 1.263(a)- 4(b)(1)(i).

Section 1.263(a)-4(b)(1)(ii) provides that, in general, a taxpayer must capitalize an amount paid to create an intangible described in § 1.263(a)-4(d). The Payment is not one of the types of created intangibles that are listed in § 1.263(a)-4(d). Therefore, the Payment is not a created intangible.

Also, the Payment was not made to create or enhance a future benefit identified in the Federal Register or the Internal Revenue Bulletin. Further, the Payment was not made to facilitate the acquisition or creation of an intangible. Therefore § 1.263(a)-4(b)(1)(iv) and (v) do not apply to the Payment.

Accordingly, the Payment is not an intangible described in § 1.263(a)-4(b)(1) and is not required to be capitalized under that section.

CONCLUSIONS

(1) The Payment by Association is deductible under § 162(a).

(2) Association is not required to capitalize the Payment under § 263(a).

Except as expressly provided herein, no opinion is expressed or implied concerning the tax consequences of any aspect of any transaction or item discussed or referenced in this letter. Specifically, no opinion is expressed on whether Association is an insurance company under § 832 or on what type of entity Association is under the rules of § 7701. Also, no opinion is expressed on what is the proper year for deduction of the Payment under § 461 or on whether the Payment is a tax under § 164.

This ruling is directed only to the taxpayer requesting it. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

A copy of this letter must be attached to any income tax return to which it is relevant. Alternatively, taxpayers filing their returns electronically may satisfy this requirement by attaching a statement to their return that provides the date and control number of the letter ruling.

The rulings contained in this letter are based upon information and representations submitted by the taxpayer and accompanied by a penalty of perjury statement executed by an appropriate party. While this office has not verified any of the material submitted in support of the request for rulings, it is subject to verification on examination.

Sincerely,

David M. Christensen
Assistant to the Branch Chief, Branch 2
(Income Tax & Accounting)