OFFICE OF
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DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR

FROM: JOEL E. HELKE, Chief CC:DOM:FS:FI&P

SUBJECT:

This Field Service Advice responds to your memorandum dated September 22, 1998. Field Service Advice is not binding on Examination or Appeals and is not a final case determination. This document is not to be cited as precedent.

LEGEND:

Company A =
Company B =

Company C =
Company D =
Insurance Program =
City 1 =
City 2 =
State 1 =
State 2 =
Offshore Domicile =
Court =
Date 1 =
Date 2 =
Date 3 =
Date 4 =
Date 5 =
Date 6 =

Month 1	=
Year 1	=
Year 2	=
Year 3	=
$t	=
$u	=
$v	=
$w	=
$x	=
$y	=
$z	=

ISSUES:

1. Whether certain amounts paid by Company A to Company B in connection with the Insurance Program during the taxable years ended Date 2, and Date 3, are deductible as insurance premiums under I.R.C. § 162.[1]

2. If the amounts at issue are deductible as insurance premiums under section 162, whether such payments are nevertheless not deductible in the taxable years at issue because it cannot be determined that the requisite levels of risk shifting and risk sharing occurred during those taxable years.

3. If the amounts at issue are not deductible as insurance premiums under section 162, whether such amounts, to the extent they exceed claims actually paid for the taxable years at issue, create an addition to Company A's capital investment in Company C that increases Company A's cost basis in Company C.

CONCLUSIONS:

1. As we understand the facts in this case, Company A's notional redemption account maintained in connection with the Insurance Program could be reduced by losses of other participants in the Insurance Program up until the time of the redemption of its preferred stock in Company C. If our understanding of the facts is correct, we determine that the Seventh Circuit Court of Appeals, to which an appeal would lie in this case, would conclude that adequate risk distribution (and therefore,

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[1] Unless otherwise indicated, section references throughout are to the Internal Revenue Code of 1986, as amended, and the Treasury regulations promulgated thereunder, as in effect during the years at issue.

risk shifting) were present, and that, therefore, the amounts at issue represent deductible insurance premiums under section 162.

2. If Company A's insurance coverage ended when its preferred stock in Company C was redeemed in Year 2, insurance premiums paid in the taxable years ended Date 2, and Date 3, should be capitalized and amortized through the date of redemption in Year 2. If, however, Company A's insurance coverage ended when it withdrew from the Insurance Program in Year 1, the amounts at issue should not be capitalized and amortized.

3. Since we have previously concluded, based on our understanding of the facts, that the Seventh Circuit would likely conclude the amounts at issue are deductible as insurance premiums under section 162, we will not address this argument.

FACTS:

The relevant facts, as we understand them, are derived from your request for Field Service Advice. Company A is a State 1 corporation primarily engaged in the business of building power transmission lines for utility companies. During the taxable year ended Date 1, Company A acquired preferred stock in Company C, a Offshore Domicile corporation, for a $t capital contribution. Company C's sole business was to provide for the insurance of its U.S. shareholders through the Insurance Program. During the taxable years at issue, Company A maintained insurance policies with Company C which provided coverage for workers' compensation, automobile, and general liability.

Upon entering the Insurance Program, each participant was required to purchase voting redeemable shares in Company C. The purchase of such shares was necessary in order to meet the Offshore Domicile's minimum premium-to-surplus requirements and was also used as a device to return income and underwriting profits back to the participants. An individual participant's equity contribution could be used to offset Company C's underwriting losses with respect to the participant, and Company C's underwriting gains with respect to an individual participant would be allocated back to the participant's equity account. Company C's underwriting losses from one year with respect to an individual participant would be charged against Company C's underwriting gains in prior years, if any, with respect to the participant.

Company C established a separate "redemption account" for each participant. The redemption accounts were utilized to determine the redemption price of shares and to calculate dividends payable to individual participants. Additions to a redemption account consisted of premiums paid by an individual participant, the participant's contributed capital, and investment income attributable thereto. Subtractions from a redemption account consisted of claims paid by Company C with respect to the participant, as well as loss handling fees, administrative fees relating thereto, excess insurance charges attributable to the participant, risk pool charges, and previously paid dividends.

The Insurance Program required that program participants purchase an insurance policy from Company B. Company B is a member of Company D, which is a domestic publicly traded company. A participant in the program paid a "premium" to Company B, which then "reinsured" a portion of the coverage with Company C. Company B retained liability for individual losses in excess of $v and Company C assumed liability for individual losses up to $v. A portion of the annual "premium" paid by a participant was retained by Company B for the coverage, including costs and administrative expenses, that Company B provided. The remainder was remitted by Company B to Company C.

Company C added the premiums remitted to it by Company B, less expenses and administrative costs, to reserves. At the same time, Company C created several notional accounts to which reserves were allocated. One such notional account was a "risk pool account." The amounts notionally allocated to the risk pool were used to pay claim amounts between $u and $v. The amount of a participant's premium received by Company C not notionally allocated to the risk pool would be notionally allocated back to that participant's redemption account. An individual participant's redemption account was then used to pay claims up to $u against that participant.

Thus, under the Insurance Program, there were three levels of coverage. Claim amounts against a participant up to $u were paid from that participant's redemption account (First Level Coverage). Claim amounts against a participant between $u to $v (Second Level Coverage) were paid from the risk pool. Claim amounts exceeding $v (Third Level Coverage) were paid by Company B.

At any given time, the amount in the risk pool consisted of reserve amounts allocated by Company C to the risk pool and earnings on these amounts reduced by claims paid therefrom and administrative charges and expenses against the risk pool. If the risk pool became depleted so that it lacked funds to pay claims against it any additional claim that otherwise would be paid from the risk pool was instead charged against the redemption account of the participant against which the claim was made.

Thus, a participant's notional redemption account consisted of the initial $t capital contribution, all "premiums" paid by it, plus interest thereon, less the total of the amounts retained by Company B, the participant's allocations to the risk pool, paid claims up to $u against the participant, and administrative costs and expenses related thereto.

For the taxable years ended Date 2, and Date 3, Company A claimed insurance deductions in the amounts of $w and $x, respectively, relating to its participation in the Insurance Program. The Service examined Company A for the taxable years ended Date 2, Date 3, and Date 4. The Revenue Agent allowed the portions of the deductions relating to the Second and Third Level Coverages on the theory that there was genuine risk shifting and risk distribution with respect to those coverage levels. However, the Revenue Agent disallowed the portion of the deductions relating to First Level Coverage, specifically, $y for the taxable year ended Date 2, and $z for the taxable year ended Date 3.

The Revenue Agent took the position that the redemption account constituted, in essence, a "bank account" that was a self-insurance reserve for a participant's First Level Coverage and that this redemption account would be paid to a participant upon withdrawal from the Insurance Program. The Revenue Agent acknowledged that, under certain circumstances, the deposits to a participant's redemption account could be used to pay deficits of other participants, but attributed this to a risk of the participant's capital rather than a sharing of insurance risk.

The Revenue Agent further noted that while an individual participant with a positive redemption account balance could be charged for other participants' losses, such charges would not actually occur until the participant actually left the Insurance Program. For example, Company A's redemption account was not actually debited to reflect other members' negative balances until Company A chose to leave the program in Year 1, and no monetary reduction was made until Company C actually redeemed Company A's stock in Year 2. Thus, the loss by Company A of a portion of its redemption account to replenish negative accounts of other participants did not occur during the years at issue.

On Date 5, the City 1, State 1 Appeals Office ("Appeals") issued a statutory notice of deficiency ("SNOD") to Company A for the taxable years ended Date 2, Date 3, and Date 4. In the SNOD, Appeals disallowed portions of Company A's deductions for insurance expense, specifically, $y for the taxable year ended Date 2, and $z for the taxable year ended Date 3. On Date 6, Company A filed a petition in Court. The case is currently set for trial in City 2, State 2 in Month 1 of Year 3.

LAW AND ANALYSIS

Issue 1

First, we will consider whether the First Level Coverage amounts paid by Company A under the Company C plan are deductible as insurance premiums. In order to address the issue of whether these amounts constitute payments for insurance for federal income tax purposes, it is necessary to understand how the

Internal Revenue Code provides for the treatment of insurance. 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. Treas. Reg. § 1.162-1(a) provides, in part, that among the items included in deductible business expenses are insurance premiums against fire, storms, theft, accident, or other similar losses.

Although the Code and regulations lack a definition of insurance, it is well settled that a corporation cannot deduct under section 162(a) a reserve set up to cover its own losses. Anesthesia Service Medical Group, Inc. v. Commissioner, 85 T.C. 1031 (1985), aff'd, 825 F.2d 241 (9th Cir. 1987); Spring Canyon Coal Co. v. Commissioner, 43 F.2d 78 (10th Cir. 1930). Much of the modern case law defining insurance has begun with the Supreme Court's description of insurance as requiring both risk shifting and risk distribution. Helvering v. Le Gierse, 312 U.S. 531, 539 (1941). The meaning of risk shifting and risk distribution has been litigated for several years, primarily in the captive insurance company context, in which a taxpayer places its insurance business with a corporate entity which is owned by or related to the taxpayer.

The Tax Court has applied the holding of Le Gierse, an estate tax case, to contemporary business planning in three cases, in which significant third party risks were also underwritten by the insurance company subsidiary. AMERCO v. Commissioner, 96 T.C. 18 (1991), aff'd, 979 F.2d 162 (9th Cir. 1992); The Harper Group v. Commissioner, 96 T.C. 45 (1991), aff'd, 979 F.2d 1341 (9th Cir. 1992); and Sears Roebuck and Co. v. Commissioner, 96 T.C. 61 (1991), aff'd in part and rev'd in part, 972 F.2d 858 (7th Cir. 1992). The Tax Court set forth the following "framework" for determining whether insurance exists: (1) The transaction must involve "insurance risk;" (2) the transaction must involve "risk shifting" and "risk distribution;" and (3) the transaction must constitute "insurance" in that terms's commonly accepted sense. 96 T.C. at 38, 58. In AMERCO, Harper, and Sears, the Tax Court determined that its three-pronged test was satisfied, i.e., a valid insurance arrangement existed. The Tax Court also distinguished captive subsidiaries which write policies for the parent corporation but few or no others from bona fide insurance companies that deal with their corporate parents or sibling at market terms. 96 T.C. 61 (1991).

On appeal in Sears, the Seventh Circuit Court of Appeals affirmed the Tax Court's decision on this point, but broke with decided precedent and rejected the Le Gierse definition of insurance. The court stated that in its opinion there was no insurable risk in Le Gierse, and added that "it is a blunder to treat a phrase in an opinion as if it were statutory language." 972 F.2d 858, 861. The court also rejected the Tax Court's three-pronged test to determine whether an arrangement constitutes insurance for federal tax purposes.

In its analysis, the Seventh Circuit concluded that corporations insure to spread the costs of casualties over time. The court then rejected risk shifting as a necessary element of insurance, but embraced risk distribution, or "pooling." In so doing, the court agreed with the view of an expert witness for Sears that "insurance does not shift risk so much as the pooling transforms and diminishes risk." In effect, the court seemed to suggest that, given a sufficient degree of risk distribution, risk shifting is irrelevant to the determination of whether a valid insurance arrangement exists for federal tax purposes.

The Seventh Circuit also pointed out that the insurance subsidiary in Sears provided Sears with the same hedging and administration services it provides to outsiders and that the states recognize the arrangement as "real" insurance. Finally, the court suggested that, rather than asking "What is insurance?", the relevant inquiry should be "Is there adequate reason to recharacterize this transaction?" 972 F.2d 858, 864. From this perspective, the issue would become factual, i.e, whether the arrangement possesses substance independent of the form of the corporate structure. Under this alternative analysis, the court observed that the arrangement had substance independent of its tax effects.

In affirming the Tax Court decisions in AMERCO and Harper, the Ninth Circuit Court of Appeals chose to adopt a more traditional analysis. Unlike the Seventh Circuit in Sears, the court agreed with both the Le Gierse definition of insurance and the Tax Court's three-pronged definition of insurance. The court found risk shifting and risk distribution in both cases. In discussing risk shifting, the court, like the Seventh Circuit in Sears, focused on the "pool" that resulted from the presence of significant unrelated business. Unlike the Seventh Circuit, however, which equated pooling with risk distribution and determined that sufficient risk distribution reduced the significance of risk shifting, the Ninth Circuit concluded that risk shifting can result from sufficient pooling. Finally, the court noted its agreement with the Seventh Circuit, that, rather than analyzing the case based on the definition of insurance, it might be more useful to focus on whether there is adequate reason to recharacterize the transaction. Under this analysis, the court observed that the arrangement at issue had substance independent of its tax effect.

In Rev. Rul. 78-338, 1978 C.B. 107, the Service acknowledged that risk shifting and risk distribution can occur where shareholders insure their risk with an offshore subsidiary, if there are a sufficient number of shareholders and the risks of each are a small fraction of the whole. In that ruling, the captive was owned by 31 unrelated parties, no shareholder owned a controlling interest, and no shareholder's coverage exceeded 5% of the total risks insured. In its brief analysis, the Service cited Le Gierse, supra, and concluded that, because the taxpayer and the other insureds-shareholders were not economically related, the economic risk of loss could be shifted and distributed among the shareholders who compirse the insured group.

The Revenue Agent concluded that the pooling arrangement at issue in Rev. Rul. 78-338 is similar to the arrangement between Company C and Company A, with one exception. The Revenue Agent noted that in the fact pattern considered in the revenue ruling, there was a true "pooling" of premiums with the insured parties transferring their individual risks to the group for subsequent distribution within the group but that, in the instant case, Company C does not assume risk for the "self-insurance" portion of Company A's First Level Coverage premiums, nor does it distribute this risk to other insureds within the group. Therefore, the Revenue Agent concluded, there is no risk shifting or risk distribution with respect to the First Level Coverage in the Insurance Program.

As we understand the facts, however, Company A's notional redemption account could be reduced by losses of other participants up until the time of the redemption of the individual participant's preferred stock in Company C (Year 2 in this case). If our understanding of the facts is correct, it is not likely that the Revenue Agent's argument would prevail in the Seventh Circuit, to which an appeal would lie in this case. Rather, in our view, the Seventh Circuit would apply its holding in Sears, supra, and conclude that adequate risk distribution (and therefore, risk shifting) were present.

Issue 2

Next, we will consider an alternative argument raised in your request for Field Service Advice, specifically, if the amounts at issue are deductible as insurance premiums under section 162, then whether such payments should be capitalized as relating to insurance coverage for future taxable years.

The Tax Court has previously considered capitalization of insurance premiums in Black Hills Corp. v. Commissioner, 101 T.C. 17 (1993), revised, 102 T.C. 505 (1994), aff'd, 73 F.3d 799 (8th Cir. 1996). In its original opinion, the Tax Court determined that a reserve account created by the taxpayer's payment of premiums for black lung benefits constituted a distinct asset, and that the premiums were thus, in general, nondeductible capital expenditures under the holding of Commissioner v. Lincoln Savings & Loan Association, 403 U.S. 345, 353 (1971). In a supplemental opinion, the Tax Court reconsidered its holding under Lincoln Savings, and modified its opinion to specifically rely on Indopco, Inc. v. Commissioner, 112 S.Ct. 1039 (1992). The Eighth Circuit Court of Appeals concluded that the record supported the Tax Court's finding that the premiums paid produced significant benefits beyond the taxable years at issue, and upheld the Tax Court's decision.

From the facts presented, Company A's notional redemption account continued to be at risk after its withdrawal from the Insurance Program in Year 1, until the redemption of its preferred stock in Company C in Year 2. It is not clear from the facts presented, however, whether Company A received insurance coverage during this time period. If Company A continued to receive insurance coverage through the redemption date in Year 2, based on insurance premiums paid during the taxable years ended Date 2, and Date 3, the insurance premiums should be capitalized and amortized through the date of redemption in Year 2, in accordance with Black Hills. If, however, Company A's insurance coverage ended when it withdrew from the Insurance Program in Year 1, we do not recommend that the amounts at issue be capitalized and amortized.

Issue 3

Finally, we will briefly reference an additional alternative argument raised in your request for Field Service Advice, specifically, if the amounts at issue are not deductible as insurance premiums under section 162, whether such amounts, to the extent they exceed claims actually paid for the taxable years at issue, create an addition to Company A's capital investment in Company C that increases Company A's cost basis in Company C. Since we have previously concluded, based on our understanding of the facts, that the Seventh Circuit would likely conclude the amounts at issue are deductible as insurance premiums under section 162, we do not see the need to address this argument.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS:

[redacted]