INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM
FEBRUARY 9, 1999

Third Party Contact:
Index (UIL) No.: 162.04-02

Number: **199924001**
Release Date: 6/18/1999

CASE MIS No.: TAM-120807-98

Chief, Appeals

Taxpayer's Name:
Taxpayer's Address:

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

LEGEND:

Taxpayer =

Insurance Company A =

Insurance Company B =

Date 1 =

Date 2 =

Date 3 =

Date 4 =

Date 5 =

Date 6 =

State 1 =

Country 1 =

Country 2 =

Amount 1 =

Amount 2 =

Amount 3 =

Amount 4 =

Amount 5 =

Amount 6 =

Amount 7 =

Amount 8 =

Amount 9 =

Amount 10 =

ISSUE:

Whether a portion of the payment by Taxpayer to Insurance Company A for insurance coverage for tax year ended Date 1 should be disallowed under § 162 of the Internal Revenue Code as self-insurance to the extent a portion of the payment is allocated to Taxpayer's Redemption Account in Insurance Company B, as described below.

CONCLUSION:

The portion of the payment by Taxpayer to Insurance Company A for insurance coverage for tax year ended Date 1 which is allocated to Taxpayer's Redemption Account in Insurance Company B should not be disallowed under § 162 of the Internal Revenue Code as self-insurance. Taxpayer's Redemption Account is impacted by the loss experience of other participants in the program, and is not required to be refunded to Taxpayer in the event of favorable loss experience on the part of Taxpayer.

FACTS:

The pertinent facts during the relevant taxable period as agreed to by the Appeals Officer and Taxpayer are as follows. Taxpayer is a manufacturing corporation. On Date 2, Taxpayer acquired Amount 1 of redeemable preference shares ("Preference Shares") of Insurance Company B and became eligible to have its general liability, automobile and worker's compensation insurance insured by Insurance Company A and partially reinsured by Insurance Company B.

Insurance Company A is a multi-line insurer with executive offices in State 1. Insurance Company A writes property and casualty insurance for institutions and individuals nationwide and is subject to the insurance laws and regulations of each of the states in which it does business. Insurance Company A is unrelated to Taxpayer or to Insurance Company B.

Insurance Company B is an insurance corporation that is a multi-line indemnity reinsurer. Insurance Company B is domiciled in Country 1. At all times since its incorporation in 1977 to the present, Insurance Company B has complied with all Country 1 laws and regulations governing the operation of reinsurance companies domiciled there, including all requirements as to minimum capitalization and financial strength.

Insurance Company B is not licensed or admitted to carry on the business of insurance in Country 2. Taxpayer was one of approximately forty unrelated shareholders of Insurance Company B during the taxable year. Insurance Company B's business during the taxable year consisted solely of the provision of indemnity reinsurance of policies issued by Insurance Company A to Insurance Company B's shareholders. The policies issued by Insurance Company A to Taxpayer were partially reinsured by Insurance Company B during the taxable year.

The policies purchased by Taxpayer from Insurance Company A generally provided Amount 2 of coverage per occurrence and in the aggregate for general liability, Amount 3 of coverage per occurrence (with no aggregate limit) for automobile liabilities, unlimited coverage for workers' compensation liability and Amount 3 of coverage per occurrence/accident (with no aggregate limit) for employers' liability.

Taxpayer paid the premiums for each of the Insurance Company A policies in their entirety in the year of coverage. The premiums charged for the Insurance Company A policies were not subject to subsequent adjustment. Consequently, Taxpayer could not be assessed additional premiums in the event that its losses insured under the Insurance Company A policies exceeded the premiums initially charged therefor, and Insurance Company A was not obligated to pay Taxpayer dividends, refunds or any other return of premiums in excess of insured losses incurred during the periods of coverage.

During the taxable year, Insurance Company A purchased indemnity reinsurance from Insurance Company B with respect to a portion of the risks Insurance Company A assumed under policies of insurance issued to Insurance Company B's shareholders. Pursuant to a reinsurance agreement entered into between Insurance Company A and Insurance Company B ("Reinsurance Agreement"), Insurance Company B agreed to indemnify Insurance Company A for that portion of losses incurred by Insurance Company A attributable to the first Amount 4 of coverage per occurrence provided to Insurance Company B's shareholders under insurance policies issued by Insurance Company A.

Insurance Company A did not reinsure with Insurance Company B that portion of its liabilities assumed under policies issued to Insurance Company B's shareholders that was in excess of Amount 4 per occurrence. There was no aggregate limit on Insurance Company B's exposure to Insurance Company A for Taxpayer's risks.

Pursuant to the Reinsurance Agreement, Insurance Company B agreed to indemnify Insurance Company A, as described above, in exchange for a portion of the premiums received by Insurance Company A from Insurance Company B's shareholders. Insurance Company A received premiums from Taxpayer and retained amounts to reimburse Insurance Company A's acquisition expenses (including ceding commissions and applicable Federal Excise Taxes), amounts for the retention of liabilities assumed by Insurance Company A under the underlying policies in excess of Amount 4 per occurrence, and other items. Insurance Company A paid the remainder of Taxpayer's premiums to Insurance Company B for reinsurance.

During the taxable year at issue, Insurance Company B had two classes of shares outstanding. Ordinary shares, which ceased being issued prior to the taxable year at issue, carried rights only to distributions in liquidation of the company. Preference Shares carried rights to participate in dividend distributions and to redemption. All dividends on and redemptions of Preference Shares are subject to the discretion of Insurance Company B's board of directors. The board of Insurance Company B may not declare a dividend or approve a redemption if such dividend or redemption causes Insurance Company B to cease to meet requirements as to financial condition imposed by Country 1 statute. Insurance Company B's board of directors is also prevented from declaring a dividend or approving a redemption of Preference Shares if insufficient funds are available due to Insurance Company B's obligation to fund its letter of credit obligations under the Reinsurance Agreement.

A corporation becomes a shareholder of Insurance Company B by purchasing Preference Shares. Insurance Company B's shareholders are under no obligation to purchase additional Preference Shares or to otherwise contribute to the capital of Insurance Company B beyond the original purchase price of their Preference Shares.

To become a holder of Preference Shares in Insurance Company B ("Member"), new Members are required initially to purchase insurance coverage from Insurance

Company A, a portion of which is reinsured with Insurance Company B. However, there is no requirement that Members continue to purchase such insurance from Insurance Company A beyond the first year of membership. During the taxable year, several Members continued to hold Preference Shares of Insurance Company B but did not also simultaneously purchase insurance policies from Insurance Company A. Taxpayer stopped purchasing insurance from Insurance Company A in the tax year following tax year ended Date 1, but remained a Member until Date 3.

Insurance Company B establishes a Redemption Account for each Member to allocate the company's surplus, if any, when and if such allocations are required. The balance in a Member's Redemption Account is a factor used in negotiations to determine the redemption price of the Member's Preference Shares and is used to determine the Member's proportionate right to any dividends declared by Insurance Company B's board of directors. Members have no rights to any amounts reflected in their Redemption Accounts except as approved by the Insurance Company B board of directors.

The amount reflected in each Member's Redemption Account consists of several items, beginning with the issue price of the Member's Preference Shares and subject to several adjustments. Each Member's Redemption Account is adjusted for underwriting profits and losses, if any, associated with that portion of the Member's insurance purchased from Insurance Company A and reinsured by Insurance Company B covering the first Amount 5 per occurrence ("First Layer Coverage"). Such underwriting profits and losses are generally calculated by taking into account premiums allocated by Insurance Company B for the Member's First Layer Coverage and underwriting expenses associated with the Member's First Layer Coverage, including losses paid, fees and reserve charges. Additional adjustments to each Member's Redemption Account includes allocations for the Member's share of Insurance Company B's earnings from its investments and applicable administration expenses, if any, and reductions for dividends paid.

Each Member's Redemption Account is also adjusted by allocations to and from a pool set up to remove short-term volatility associated with severity losses attributable to the indemnification reinsurance coverage undertaken by Insurance Company B ("Pool"). Similar to the Redemption Accounts, the Pool does not represent a segregation of any particular assets. There is no "account" for the Pool, but rather it is an "off-line" element of the calculation of the Members' Redemption Accounts. The Pool serves as a buffer layer covering incurred losses in excess of Amount 5 per occurrence and below Insurance Company B's limit of Amount 4 per occurrence ("Pool Coverage"). In general, 10% of premiums are allocated to the Pool. Through a variety of allocation calculations, the various Redemption Accounts share in shortfall or profits of Insurance Company B's Pool Coverage. Additionally, the Pool is used as a buffer for any Redemption Accounts which become negative.

If the balance of the Pool account is positive, the positive balance is allocated to the Redemption Accounts. In the event the Pool account does not have sufficient allocated premiums and earnings to offset underwriting losses in the Amount 5 to Amount 4 layer and offset negative Redemption Account balances, the amount of the shortfall necessarily falls to the Redemption Account balances of the Members with positive balances. Although such reductions to individual Redemption Accounts can theoretically be reversed by allocations from the Pool account positive balances in subsequent years, there is no guaranty that sufficient positive balances will become available in subsequent years for this purpose.

The balance in any Member's Redemption Account can be positive or negative. The balance depends upon several factors, including favorable or unfavorable underwriting results of the Member's First Layer Coverage purchased from Insurance Company A and reinsured by Insurance Company B, if any; allocations to and from the Pool attributable to the rest of Insurance Company B's coverage, if any; reductions attributable to the Member's share of the negative Redemption Account balances of other Members; and Insurance Company B's investment earnings, if any.

The Redemption Accounts of several Members contained negative balances during the taxable year at issue. These Members were not required, however, to make up negative balances by either continuing to purchase Insurance Company A insurance policies or by making additional payments of any kind, including insurance premiums or equity contributions. Consequently, when a Member with a negative Redemption Account balance stops purchasing insurance coverage from Insurance Company A, the Member's Redemption Account balance can remain negative until the Member's Preference Shares are redeemed.

Several Members carried substantial negative account balances in their Redemption Accounts long after they had ceased purchasing insurance coverage from Insurance Company A. Such negative balances were attributable to unfavorable underwriting experience with respect to the Member's first layer and/or to Pool Coverage. Because of the persistence of negative balances in Redemption Accounts, there was no correlation between Insurance Company B's Shareholders' Equity and the sum of its Redemption Accounts with positive balances, nor was there any correlation between a Member's Redemption Account and the amount the Member could receive on redemption of its Preference Shares or on liquidation of Insurance Company B.

Any Member can apply to Insurance Company B's board of directors to have its Preference Shares redeemed. Approval of a Member's request for redemption is subject to the board's discretion. Insurance Company B's board may decide not to redeem the Preference Shares of a Member with a positive Redemption Account balance for any reason. A Member with a positive Redemption Account balance may receive payment in redemption of its Preference Shares only if the balance is still positive after all adjustments required to bring the Redemption Account up to date have been made.

In Date 3, five Members with positive Redemption Account balances, including Taxpayer, successfully requested redemption of their Preference Shares. In each case, however, the amount actually received in redemption was significantly less than the Member's Redemption Account balance at Date 4.[1] The main reason for this shortfall was the allocations of negative Redemption Account balances of other Members due to unfavorable underwriting results associated with the insurance policies purchased from Insurance Company A by those other Members. In other words, the unfavorable underwriting experience of other Members had a significant and direct impact on the amount which Taxpayer ultimately received on redemption of its Preference Shares in Insurance Company B.

Taxpayer continued to own Preference Shares of Insurance Company B after Taxpayer ceased purchasing insurance from Insurance Company A because Insurance Company B was unable or unwilling to redeem Taxpayer's Preference Shares. Taxpayer's investment in Insurance Company B remained at risk even though Taxpayer no longer obtained coverage from Insurance Company A.

Finally, in Date 3, Insurance Company B's board of directors agreed to redeem Taxpayer's Preference Shares. The price at which Taxpayer's Preference Shares were redeemed is reflected in an exhibit to Taxpayer's submission illustrating the activity of Taxpayer's Redemption Account. The exhibit demonstrates that the balance in Taxpayer's Redemption Account was reduced by Amount 6 to reflect allocations to the Pool account to cover Taxpayer's allocable share of shortfalls in the Pool account caused by underwriting losses of all Members. Taxpayer's Redemption Account was further reduced by Amount 7 to reflect Taxpayer's allocable share of the negative Redemption Account balances of other Members. Although Taxpayer's Redemption Account balance at Date 4 was Amount 8 (after the Amount 6 allocation of Pool shortfall), the adjustments described above for the allocation of negative Redemption Account balances of other Members, as well as other concessions, resulted in Taxpayer receiving only Amount 9 in redemption of its Preference Shares. Taxpayer's Redemption Account, and the amount which Taxpayer received on liquidation of its interest in Insurance Company B, was reduced by Amount 10 because of Insurance Company B's underwriting losses incurred with respect to other Members.

LAW AND ANALYSIS:

Section 162(a) of the Internal Revenue Code 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.

---

[1] Insurance Company B's program year runs from Date 5 to Date 6.

Section 1.162-1(a) of the Income Tax Regulations provides, in part, that among the items included in business expenses for which a deduction is allowed are insurance premiums against fire, storms, theft, accident, or other similar losses in the case of a business.

Neither the Internal Revenue Code nor the regulations thereunder define the terms “insurance” or “insurance contract.” The accepted definition of “insurance” for Federal tax purposes dates back to *Helvering v. Le Gierse*, 312 U.S. 531 (1941), in which the Supreme Court stated that “[h]istorically and commonly insurance involves risk-shifting and risk-distributing.” *Id*. at 539. The sharing and distribution of the insurance risk by all of the parties insured is essential to the concept of true insurance. *See Commissioner v. Treganowan*, 183 F.2d 288, 291 (2nd Cir.), *cert. denied*, 340 U.S. 853 (1950). Thus, when there is no economic shift or distribution of the risk “insured,” the contract is not one of insurance, and the payments therefor are not deductible under § 162 of the Code. Rev. Rul. 77-316, 1977-2 C.B. 53.

Both the Internal Revenue Service and the courts have long held that amounts set aside by a taxpayer as a reserve for self-insurance, though equal to commercial insurance premiums, are not deductible for Federal income tax purposes as “ordinary and necessary expenses paid or incurred during the taxable year.” *See* Rev. Rul. 60-275, 1960-2 C.B. 43 and *Pan American Hide Co. v. Commissioner*, 1 B.T.A. 1249 (1925). Even if a self-insurance fund is administered by an independent agent, that fact does not make payments to the fund deductible. *See Spring Canyon Coal Company v. Commissioner*, 43 F.2d 78(10th Cir. 1930), *cert. denied*, 284 U.S. 654 (1930).

In determining the propriety of claimed insurance deductions by a company to a related company, the following three prong test must be applied, and each part must be satisfied:

(1) The arrangement must involve the existence of an “insurance risk”;

(2) There must be both risk shifting and risk distribution; and

(3) The arrangement must be for “insurance” in its commonly accepted sense.

See Amerco v. Commissioner, 979 F.2d 162 (9th Cir. 1993), *aff’g* 96 T.C. 18 (1991), cited with approval in *Harper Group v. Commissioner*, 96 T.C. 45, 58 (1991), *aff’d* 979 F.2d 1341 (9th Cir. 1992).

Risk is a basic element of any insurance transaction. An insured faces some hazard; an insurer accepts a premium and agrees to perform some act if or when the loss event occurs. If no risk exists, then insurance cannot be present. *Amerco v. Commissioner*, 96 T.C. 18 at 38-39 (1991), *aff’d* 979 F.2d 162 (9th Cir. 1993).

Positions of the Parties

The Appeals Officer takes the position that the portion of the payment made to Insurance Company A which is ceded to Insurance Company B and ultimately allocated to Taxpayer's Redemption Account is not deductible as a premium "paid" for "insurance." The Appeals Officer believes that because the Redemption Account is adjusted for claims made by Taxpayer, and because the Redemption Account was actually redeemed by Taxpayer in Date 3, the amounts paid into the Redemption Account during the taxable year at issue are amounts set aside for self-insurance.

Taxpayer argues that the fact that Taxpayer's Redemption Account is adjusted by claims made by Taxpayer does not in and of itself establish that amounts paid into the Redemption Account are amounts set aside for self-insurance. Taxpayer points out that losses of other participants reduce the value of Taxpayer's Redemption Account. Taxpayer's Redemption Account may in fact be negative. Taxpayer argues that the Redemption Account is merely a method by which Taxpayer's equity interest in Insurance Company B is measured.

Discussion

The Appeals Officer does not dispute that Taxpayer's arrangement involves the existence of an insurance risk. Nor does the Appeals Officer dispute that the coverage purchased is insurance in its commonly accepted sense. The Appeals Officer maintains that true risk shifting and risk distribution does not occur with respect to the portion of Taxpayer's insurance coverage assigned to the Redemption Account. The Appeals Officer points out that claims made by Taxpayer up to Amount 3 are applied directly against the balance in Taxpayer's Redemption Account, and that Taxpayer may redeem its Redemption Account upon request. Taxpayer's Redemption Account is, however, impacted by the negative experience of other participants. It thus follows that even if Taxpayer made no claims whatsoever which would be applied to reduce the Redemption Account, adverse experience by other participants could reduce Taxpayer's Redemption Account, and this reduction was not subject to limitation. In fact, the adverse experience of other participants could reduce Taxpayer's Redemption Account to a negative amount. Conversely, while Taxpayer's own adverse experience could also reduce Taxpayer's Redemption Account to a negative amount, no additional premium could be charged by Insurance Company A for the relevant coverage.

Taxpayer's Redemption Account is subject to adjustment due to the negative experience of other participants. Taxpayer has no right to the return of amounts paid into the Redemption Account even if Taxpayer has no insurance claims which would otherwise reduce the balance of Taxpayer's Redemption Account. Taxpayer's premiums could not be adjusted to accommodate unexpectedly adverse loss experience suffered by Taxpayer. These facts establish that the portion of the payment made to Insurance Company A which is ceded to Insurance Company B and ultimately allocated to the Redemption Account with respect to claims up to Amount 5 satisfies both the concept of risk shifting (from Taxpayer to Insurance Company A to Insurance Company B) and risk distribution (among all participants holding Redemption Accounts).

CAVEAT(S)

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