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

OFFICE OF
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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR
ASSOCIATE DISTRICT COUNSEL

FROM: DEBORAH A. BUTLER
ASSISTANT CHIEF COUNSEL CC:DOM:FS

SUBJECT:

This Field Service Advice responds to your memorandum dated July 23, 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:

Insurer	=
A	=
B	=
C	=
Taxpayer	=
Date 1	=
Year 1	=
Date 2	=
Year 2	=
$x	=
$y	=

ISSUE:

Whether premiums paid by B and C for prior acts coverage, reported on Taxpayer's Year 1 and Year 2 tax returns, must be capitalized under I.R.C. § 263.

CONCLUSION:

The premiums paid for prior acts coverage created or enhanced a capital asset and provide Taxpayer with a substantial long-term benefit. Thus, Taxpayer must capitalize the premiums under I.R.C. § 263.

FACTS:

For years prior to Date 1, Insurer was a subsidiary and captive insurer of A. On Date 1, A merged with B. B filed a short period return for Year 1. B was merged into C, forming Taxpayer, on Date 2. After both mergers, Insurer remained the captive insurer of Taxpayer. Insurer provided insurance coverage for and general liability risks incurred at facilities.

On its Year 1 return, Taxpayer (as successor to B) deducted as an ordinary and necessary business expense under section 162 a $x premium paid to Insurer for "prior acts coverage." The prior acts coverage provided by Insurer were associated with B. B had maintained, prior to the merger on Date 1, "claims made basis liability coverage" and/or self-insurance.

On its Year 2 return, Taxpayer deducted pursuant to section 162 a $y premium paid to Insurer for prior acts coverage. The prior acts coverage provided by Insurer were associated with C. C too had maintained, prior to the merger on Date 2, claims made basis liability coverage and/or self-insurance. It appears at this time that Insurer reported the premium receipts as income and established fully offsetting reserves for estimated claims liabilities, so that it reported no net taxable income on the transactions in either Year 1 or Year 2.

The time remaining after policy expiration during which claims may continue to be asserted is known as the "tail." That tail can be quite long for claims, because of the and the If claims made insurance is permitted to lapse, then retroactive coverage for all incurred but not reported (IBNR) claims lapses with it. The result can be significant liability exposure of the former insured for the duration of the tail. Of course, for periods or layers of self-insurance, the company simply continues to bear one hundred percent of the liability exposure for IBNR claims. B and C both had claims made and self-insured tail exposure from multiple years prior to the mergers forming Taxpayer.

Commercial insurance is available for tail exposure left over from previous claims made policies, under the rubric of "prior acts coverage." The issuing company steps into the shoes of the previous insurer by picking up responsibility for claims arising since the retroactive date (the inception date of the original policy) of the earlier company's policy. Commercial insurers are willing to do so in large part because the assumed risk has previously been subjected to the rigors of the underwriting process.

However, for self-insured exposures, there is no previously underwriting evaluation to define and control the risk. It is a case of underwriting the risk that an uninsured event which has already happened will be reported. Commercial insurers are usually reluctant to indemnify previously uninsured risks. But the B and C's tail exposures were complications to the successful mergers, and ultimately B and C paid for, and Insurer issued, prior acts coverage.

"Claims made basis liability coverage" is a method of determining whether or not coverage is available for a specific claim. If a claim is made during the time period when a liability policy is in effect, then the insurance company is responsible for its payment, up to the limits of the policy, regardless of when the event causing the claim occurred. "Prior acts coverage" is liability insurance coverage for claims arising from acts that occurred before the beginning of the policy periods. Policies written on a claims made basis cover only claims during the policy period. Prior acts coverage is necessary for covering a claim made during a current policy period for an event that happened before a policy was in force.

Each of the underlying policies initially stated that coverage was limited to qualifying prior acts reported during the respective single policy years. However, by endorsements, Taxpayer clarified that the prior acts coverage went back to the retroactive date and covered all future claims. Taxpayer's designated personnel orally indicated that the prior acts insured in Year 1 would be covered by Insurer regardless of when reported, and that no further premium would be charged for the continuing insurance. Such amounts would cover all future reported claims. Taxpayer also indicated that the premium amount was derived from reports prepared by two actuarial firms. The $x premium appeared to be within the range recommended by the actuaries. It also appeared from the reports that the actuaries were projecting a claim runoff period of seventeen or eighteen years, and that the amounts being recommended constituted the entire outstanding exposure for IBNR claims.

Taxpayer provided responses in a later cycle which indicated that the prior acts insured in Year 2 would also be covered by Insurer regardless of when reported, and that no further premium would be charged for the continuing insurance, and that the premium covers all future years. Likewise, the $y premium paid in Year 2 appears based on a combination of actuarial computations appearing to contemplate the total period of IBNR runoff.

LAW AND ANALYSIS

Section 162 generally allows a deduction for all ordinary and necessary expenses paid or incurred during the taxable year.

Section 263 generally provides that no deduction shall be allowed for the cost of permanent improvements or betterments made to increase the value of any property. Treas. Reg. § 1.263(a)-2(a) clarifies that section 263 requires the capitalization of costs incurred to acquire property having a useful life substantially beyond the close of the taxable year.

Expenditures that otherwise are deducible under section 162 nevertheless are not deductible currently if they are also capitalizable under section 263. Sections 161 and 261; INDOPCO, Inc. v. Commissioner, 503 U.S. 79, 84 (1992); Commissioner v. Lincoln Savings & Loan Association, 403 U.S. 345, 358 (1971). Expenditures which create or enhance a capital asset must be capitalized. Commissioner v. Idaho Power Co., 418 U.S. 1 (1973).

Taxpayer has paid for continuing insurance coverage for the prior acts of B and C by making a single premium payment to Insurer. The single payment provides insurance governing the entire tail of exposure for B and C. Despite the fact that Insurer will be making payments of losses covered under the policy many years in the future, the risks transferred under the policy appear to qualify as valid insurance during the taxable years, Year 1 and Year 2. The Taxpayer appears to have laid the entire risk off on Insurer by the payment of a single premium, $x premium for prior acts of B in Year 1 and $y premium for prior acts of C in Year 2. As a result of risk transfer, Taxpayer no longer has an interest in the premiums paid and is no longer directly liable for losses. Taxpayer has indicated that the prior acts insured by Insurer would be covered regardless of when reported, and that no further premium would be charged for the continuing insurance, and that the premium covers all future years.

Taxpayer’s payments of premiums for prior acts coverage thus create a capital asset with future year coverage, requiring capitalization under Lincoln Savings and Idaho Power. The capital asset, insurance coverage, covers all future years and limits Taxpayer’s exposure to the premium paid. Additionally, payment for the insurance yields significant future benefits to Taxpayer. The insurance coverage provides relief from the risk of future payouts; it is also presently pays Insurer an amount certain to accept the risk of paying losses in the future that are uncertain in amount. Furthermore, the amounts paid, the $x premium (Year 1) and the $y premium (Year 2), appear from the actuarial reports to constitute the entire outstanding exposure for IBNR claims for B and C, respectively. Taxpayer appears to have paid a premium roughly equivalent to its total projected exposure – in essence, a prepayment of future losses.

Given these facts, Taxpayer appears to have received both a separate and distinct capital asset (the insurance policy coverage for future years) and has also received significant long-term benefits. Accordingly, Taxpayer would have to capitalize the $x premium paid in Year 1 and the $y premium paid in Year 2 under I.R.C. § 263. See Black Hills Corporation v. Commissioner, 101 T.C. 173 (1993), modified, 102 T.C. 505 (1994), aff'd, 73 F.3d 799 (8th Cir. 1996); PNC Bancorp, Inc. v. Commissioner, 110 T.C. No. 27 (June 8, 1998).

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS:

[redacted]

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If you have any further questions, please call (202) 622-7900.

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By: ______________________________
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