OFFICE OF
CHIEF COUNSEL

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224
August 22, 2000

Number: **200047021**
Release Date: 11/24/2000
CC:FIP:4/TL-N-426-00
UILC: 162.04-03;165.00-00

INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR

FROM: LON B. SMITH
Acting Associate Chief Counsel (Financial Institutions and Products) CC:FIP

SUBJECT: Disaffiliation of captive

This Field Service Advice responds to your memorandum dated May 19, 2000. Field Service Advice is not binding on Examination or Appeals and is not a final case determination. This document is not to be used or cited as precedent.

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LEGEND

Corp. C =

Corp. D =
Corp. E =

Individual A =

Date A =

Y-1 =

Y-8 =
Y-10 =

Y-13 =

Y-14 =

Y-21 =

IC =
IC2 =
IC3 =

IC4 =

s =

t =

x =

ISSUE

Whether the former parent (or its successor in interest, Corp. E) is entitled to a deduction under § 165(a) of the Internal Revenue Code for post-affiliation loss payments made by its former related insurer subsidiaries?

CONCLUSION

Corp. C/Corp. E must continue to deduct losses on amounts paid with respect to "insurance" policies/contracts within the scope of Rev. Rul. 77-316, 1977-2 C.B. 53, entered into prior to disaffiliation in accordance with the scheme outlined in that revenue ruling, i.e., under the "paid loss" deduction method described therein.

FACTS

Corp. C is engaged in business of s operations. Prior to Date A, Corp. C was a member of an affiliated group that was owned equally by two shareholders, Corp. E and Individual A. The affiliated group included companies claiming to be insurance companies, viz. IC. For the tax years Y-1 through Y-10, amounts were paid as “insurance premiums” by Corp. C to IC for coverage of its workers’ compensation liabilities attributable to the t Act. IC only insured the risks of its affiliated group and did not insure any unrelated third party business. In later years other affiliates of Corp. C were paid amounts for coverage of Corp. C workers’ compensation risks under the t Act. The additional companies claiming to be insurance companies named in the incoming request for Field Service Advice (FSA) were IC2, IC3 and IC4.[1] During the tax years Y-1 through Y-10, Corp C and its affiliates claimed insurance premium deductions for payments made to IC.[2]

The Service disallowed these premium deductions because IC and Corp. C were all members of the same affiliated group. The Service’s disallowance of Corp. C’s claimed deduction was based, in part, upon Rev. Rul. 77-316. Ultimately, the Service and Corp. C entered into settlements for some of the tax years. For example, for the Y-10 tax year, the Service disallowed 100% of the payments made to IC. The Service, however, allowed in subsequent years up to and including the tax year Y-13, deductions to Corp. C for losses and expenses paid by IC that otherwise satisfied the accounting requirements of the Internal Revenue Code.

On Date A, to resolve a dispute between Corp. E. and Individual A, the Corp. D entities were splitup in a § 355 nonrecognition transaction. In the transaction, Corp. E exchanged its 50% stock interest in the Corp. D stock for all of the stock of Corp. C. Individual A received the Corp. D stock, which directly or indirectly owned the stock of all the related insurance companies. While after the splitup Corp. C was disaffiliated from its affiliated captive insurance subsidiaries, IC and the other related insurance companies remained liable for the t Act workers’ compensation risks entered into by the parties prior to the disaffiliation. We also understand that as part of the disaffiliation transaction the former related party insurance companies would continue to receive additional premiums from Corp. C and its affiliates for coverage for a period of approximately 2 and ½ years.

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[1] We are assuming that these companies claiming to be insurance companies are related, however, the incoming FSA request did not describe the nature of the ownership relationship with respect to IC3 and IC4.

[2] Additional deductions were claimed for amounts paid as premiums to IC2 during Y-8 through Y-10.

At the time of the Date A disaffiliation, the remaining capitalized contribution amounts in IC for which Corp. C had yet to receive a deduction was approximately $x. For its fiscal tax years Y-14 through Y-21, Corp. E, the parent of Corp. C, has filed claims for refunds (actual or protective), claiming deductions for workers' compensation claims purportedly paid by IC during these years for claims apparently arising prior to the Date A disaffiliation of Corp. C/Corp. E from IC. In other words, Corp. C/Corp. E are seeking to continue the tax treatment provided for by Rev. Rul. 77-316, i.e., allowing a § 165 loss for a claim payment made by the former captive, IC, to be deductible by its former affiliate, Corp. C, in tax years subsequent to the disaffiliation.

LAW AND ANALYSIS

Section 162(a) generally allows a deduction for ordinary and necessary expenses paid or incurred during the taxable year in carrying on a trade or business. Under § 165(a), a deduction is also generally allowed for any loss sustained during the taxable year that is not compensated for by insurance or otherwise.

In Rev. Rul. 77-316, the Service concluded that an "insurer" could not insure its parent corporation or the parent's operating subsidiaries because such arrangements did not involve the requisite transfer of risk to be deemed "insurance." Thus, no immediate deduction under § 162(a) was allowed for the payments of the parent or its operating subsidiaries. Instead, Rev. Rul. 77-316 treated the parent's payments made to the insurer as nontaxable § 118 capital contributions and the payments made by the operating subsidiaries to the insurer as a § 301 dividend to the parent followed by nontaxable § 118 capital contributions by the parent to the insurer. Further, the ruling provides that when the insurer makes loss payments on behalf of: (1) the parent, such payments are treated as § 301 distributions from the insurer to the parent followed by deductible § 165 loss payments by the parent; and (2) the operating subsidiaries, such payments are treated as § 301 distributions from the insurer to the parent, capital contributions by the parent to the operating subsidiaries and deductible § 165 loss payments by the operating subsidiaries.

"Insurance" contracts entered into prior to disaffiliation do not constitute insurance transactions, and must be addressed and accounted for consistent with the rationale outlined in Rev. Rul. 77-316. Those contracts covered loss events arising under the terms of the subject contracts/policies, whether or not occurring before or after disaffiliation. The disaffiliation event is immaterial to the continued, consistent tax treatment of the non-insurance scheme outlined in the revenue ruling, whether viewed as a method of accounting or a mere consistent characterization issue. Disaffiliation does not produce a change in accounting, but a change in facts/circumstances which will require a new method for a post-disaffiliation insurance contract; the taxpayer is entitled to continue its treatment of existing transactions.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

We have restricted our comments to the post-disaffiliation claim payments that have been paid by IC to the Corp. C/Corp. E affiliated group. [redacted].

[redacted], IC2's position is not as clear as the situation involving IC because for a number of years under a settlement agreement with the Service, the former affiliated parties (e.g., Corp. C) were allowed to take [redacted]% of their premium deduction for amounts paid to IC2. In contrast, with respect to premiums paid to IC, the former affiliated parties such as Corp. C were not allowed: (1) a current § 162 deduction for premiums as they paid them prior to disaffiliation, (2) a catch-up premium upon disaffiliation,[3] or (3) a stock basis increase in the § 355 transaction as a result of following the dividend-up contribution-down approach of Rev. Rul. 77-316. On this later point involving stock basis, in the § 355 split up transaction, Corp. D distributed all of the stock of its subsidiary, Corp. C to Corp. E in exchange for all of the Corp. D stock held by Corp. E. Accordingly, under § 358(a)(1) the basis of the Corp. C stock in the hands of Corp. E was the same as the basis of the Corp. D stock surrendered by Corp. E in exchange therefor. In sum, the way that the § 358(a)(1) basis rules operate is that, generally, the tax benefits of an increase in basis resulting from the contribution portion of Rev. Rul. 77-316 dividend-up contribution-down approach did not benefit the Corp. C/Corp. E group, rather the primary benefit of increased basis ended in stock of the side of the splitup transaction that received the insurance companies. In spite of the fact that the affiliated related payers of “insurance premiums” to IC2 received the tax benefit of a § 162 deduction for premiums paid for certain tax years, this event is somewhat fortuitous, and we are reluctant to suggest that it should be the reason for departing

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3 [redacted]

from following the recharacterization provided in Rev. Rul. 77-316. [redacted]

[redacted]

Please call if you have any further questions.

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