Office of Chief Counsel
Internal Revenue Service
MEMORANDUM

Number: **200220006**
Release Date: 5/17/2002
CC:FIP:4:POSTF-148452-01
JEGlover
UIL: 9999.98-00

date: February 5, 2002

to: Associate Area Counsel (LMSB) Chicago
Attn:

from: Associate Chief Counsel, Financial Institutions & Products, Branch 4

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subject: **Request for Field Service Advice**
Non-Docketed Large Case

Legend

Taxpayer =

Date A =
Date B =
Amount C =
Amount D =
Type E =
Type F =

This responds to your September 13, 2001 memorandum requesting advice as to the capitalization of Taxpayer's expenditures to develop insurance products. Specifically, you ask whether these expenditures were for the development of "new" insurance products and, if so, whether they should be capitalized or expensed.

Taxpayer is an insurance company subject to tax under part I of subchapter L of the Internal Revenue Code. Accordingly, Code section 848 requires Taxpayer to capitalize specified policy acquisition expenses and amortize those expenses over 60 months or 120 months, as appropriate. For the reasons set forth below, we believe the capitalization requirement of section 848 trumps the application of section 263 under these circumstances, and the expenses therefore should not be capitalized under the general authority of section 263.

Discussion

Facts

According to your September 13, 2001 memorandum, prior to Date A, Taxpayer did not offer Type E or Type F insurance products. At some point, Taxpayer decided that it would be beneficial for the company to market such products. Taxpayer anticipated that it would be several years before a profit would be realized from these products.

In developing the Type E and Type F products, Taxpayer incurred expenses of the following nature:

1. general overhead
2. actuarial services
3. registration
4. legal and professional fees
5. computer expenses
6. promotional expenses
7. educational/training expenses.

Taxpayer claims that, over the years in question, it incurred $Amount C in developing the Type E policy and $Amount D in developing the Type F policy. These expenses were incurred prior to placing these products in the market.

On both its books and records and its Date A and Date B income tax returns, Taxpayer deducted the full amount of these costs as ordinary and necessary business expenses. In examining Taxpayer’s tax returns, the revenue agent asks whether these expenses should have been capitalized instead because they were for the purpose of creating a separate and distinct asset, or because they produced a significant benefit in years subsequent to the year in which they were incurred.

In considering the treatment of these expenses, you ask our assistance on two questions: First, if the Type E and Type F products were new products for Taxpayer in Date A and Date B, should the costs incurred to develop them be capitalized, and second, are these new products for Taxpayer or are they merely enhancements of products already offered by Taxpayer?

Analysis

Taxpayer argues that it is entitled to claim a current deduction for the expenses it incurred to establish the Type E and Type F products. Taxpayer appears to argue it is entitled to deduct these amounts currently, subject only to the capitalization requirements of section 848. We agree with Taxpayer that the proxy approach of section 848 generally trumps the application of section 263.

Section 848 requires an insurance company to capitalize specified policy acquisition expenses and amortize these expenses ratably over 60 months or 120 months, as appropriate. Section 848(c) defines specified policy acquisition expenses, in keeping with the proxy approach, as so much of the general deductions for such taxable year as do not exceed a stated percentage of net premiums. I.R.C. section 848(c)(1). The stated percentage varies with the precise type of insurance, be it an annuity, a life insurance policy, or other type of insurance. "General deductions, in turn, are defined as the deductions provided in part IV of subchapter B (sec. 161 and following, relating to itemized deductions) and in part I of subchapter D (sec. 401 and following, relating to pension, profit sharing, stock bonus plans, etc.). I.R.C. section 848(c)(2). In this way, section 848 operates as a proxy for identifying the actual commissions and other selling expenses incurred each year and amortizing these over the future periods in which they will produce a benefit.

When section 848 was enacted in 1990, Congress was aware of inconsistencies in the treatment of expenses within the insurance industry. First, a life insurance company was generally under no accounting requirement to capitalize its policy acquisition expenses. Instead, it deducted commissions and other selling expenses for the year in which incurred for purposes of computing its regular income tax. However, the applicable accounting rules required the same type of expenses to be capitalized if they were incurred in connection with certain reinsurance transactions. Second, a life insurance company was required to utilize generally accepted accounting principles to capitalize its policy acquisition expenses for purposes of computing its alternative minimum tax. See, e.g., Treas. Reg. section 1.56(g)-1(h). Third, property and casualty insurers did not have to capitalize such expenses for purposes of computing either their regular or alternative minimum tax. Instead, they were required to reduce their unearned premium reserve by a "haircut" set forth in section 832(b)(4). H.S. Conf. Cmte. Rep. No. 101-964, 101st Cong., 2d Session 1063 (1990).

Congress concluded that these inconsistencies contributed to the mismeasurement of the income of insurance companies. In order to strike a balance between the need to match expenses to income and the need to do so in a practical manner, Congress utilized a proxy system in section 848. Under this approach, policy acquisition expenses required to be capitalized and amortized are determined, for any taxable year, for each category of specified insurance contracts, as a percentage of the net premiums for the taxable year.

The House and Senate both attributed the mismatch to "commissions and other selling expenses for the year in which incurred." Ways and Means Cmte. Print No. 101-37, p. 26; Informal Senate Rep. on S3209 at S15690 (1990). It is our view that Congress intended section 848 to operate as a proxy for all expenses incurred by an insurance company in connection with the selling of its policies, including those incurred to develop such policies or to modify them to remain competitive.

Congress intended that expenses associated with the acquisition of a stream of income from premiums are to be capitalized as "specified policy acquisition expenses." In section 848(g), Congress specified that section 848 controls the treatment of ceding commissions on reinsurance. Ceding commissions are essentially the cost paid by a reinsurer for its right to receive the amount of premiums agreed to between the insurer and the reinsurer, i.e., a stream of future income from the premiums paid by the insureds for the ceded policies. Section 848(g) reversed the decision in Colonial Am. Life Ins. Co. v. Commissioner, 491 U.S. 244 (1989), which held that such commissions had to be capitalized. Accordingly, it is clear that Congress was considering not only direct selling expenses, but also costs associated with the acquisition of a stream of premium income when section 848 was enacted.

Moreover, section 848 was motivated by a desire to implement an administratively practicable system, at the potential detriment of having a less than economically precise system for measuring income. To implement a system that accurately capitalized and amortized policy acquisition costs would, in Congress's view, cause difficult administrative and enforcement problems. Congress was concerned that the rules which would be required to implement such an economically precise system would be inordinately complex. Hence Congress created a proxy system of section 848 to serve as the measure of the expenses incurred by an insurance company in connection with specified insurance contracts which should be capitalized. Legislative History of Ways and Means Democratic Alternative Ways and Means Cmte. Print No. 101-37, p. 27-28 (1990). We do not think that attempting to capitalize product development costs and amortizing them over the expected life of the products is consistent with the administrability Congress sought to achieve when it enacted section 848.

It does not necessarily follow that all expenses incurred by an insurance company which enters into specified insurance contracts are governed by section 848. Only those expenditures which can be said to be specified policy acquisition expenses fall within section 848's footprint. Some examples of costs that may not fall within the footprint of the section are the initial start up costs of a new insurance company; the costs incurred by an insurance company upon its initial entry into the market for specified insurance contracts; or the costs incurred with such innately capital expenditures as erecting or purchasing a building. The costs at issue in the present case, however, appear to be included within the footprint of section 848[1].

In light of our conclusion under section 848, we are not addressing whether the policies issued by Taxpayer were sufficiently “new” that the expenditures at issue would otherwise be capitalized under section 263.

Case Development, Hazards, and Other Considerations

Factually, we do not believe that Taxpayer had no Type E or Type F products prior to Date A. The products in question may not be as new for Taxpayer as you suggest. Accordingly, even if these costs were not governed by section 848, the case for capitalization may not be as strong it initially appears to be. If so, this may be a further deterrent to capitalization in this case.

You should be aware that in Equitable Life Ins. Co. v. Commissioner, T.C. Memo. 1977-299, the Court held that the

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[1]It is our view that section 848 provides the rule for the tax treatment of specified policy acquisition expenses. Even were a given expense to also constitute a research or experimental expenditure under Treas. Reg. section 1,174-2 or be described in Rev. Proc. 69-21, 1969-2 C.B. 303, section 174 and the Revenue Procedure would not govern the treatment of any expense within the footprint of section 848.

professional fees paid to register a variable annuity contract with the Securities and Exchange Commission were deductible expenses. This contract was Equitable's entry into the market of variable annuities. The costs for registering the contract were deductible because, according to the Court, by the registration Equitable did not obtain an asset or right of a capital nature; registration is required for each new or modified contract and therefore is a normal, usual, and customary expense for companies in the insurance business. Although this decision predated the enactment of section 848 and INDOPCO, Inc. v. United States, 503 U.S. 79 (1992), it provides a roadmap for deducting many expenses of exactly the same type as incurred by Taxpayer, even though the Service attempted to assert section 263(a) as authority for capitalization.

Finally, your September 13, 2001 memorandum refers to Field Service Advice, FSA 1999-1105, 17 Ins. Tax Rev. 667, issued by another office on facts similar to those in this case. Our conclusion herein is not inconsistent with that explained in the earlier FSA. The tax years involved in the earlier FSA appear to be years which ended prior to September 30, 1990, the effective date of section 848.

/S/
MARK SMITH
Chief, Branch 4
Office of Associate
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(Financial Institutions & Products)