INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

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Index (UIL) No.: 832.00-00, 162.00-00, 263.00-00
CASE MIS No.: TAM-115740-02

Director, Field Operations, LMSB

Taxpayer's Name:
Taxpayer's Address:
Taxpayer's TIN:
Years Involved:
Date of Conference:

LEGEND:

Taxpayer =
Fund =
State =
Event =
Statute 1 =
Statute 2 =
Type X =
Year A =
Year B =
Year C =
Date P =
Date Q =
$e =
$f =
$g =
R =
S =

ISSUE:

Under section 832(c)(1) of the Internal Revenue Code, is the initial assessment paid to the Fund by Taxpayer deductible as an ordinary and necessary business expense, or is the initial assessment required to be capitalized under section 263(a)?

CONCLUSION:

The initial assessment is deductible under section 832(c)(1).

FACTS:

Taxpayer is an insurance company licensed to provide insurance to homeowners in State. Taxpayer uses the accrual method of accounting. Taxpayer offers Type X insurance. Statute 1 requires all private insurance companies (Insurers) within State that offer Type X insurance to offer purchasers the opportunity to buy coverage against damage caused by an Event. In year A, Taxpayer suffered large losses caused by an Event in State. The large losses in Year A resulted in an increase in Taxpayer=s potential liability for Events in State.

In Year B, the Fund was created by an act of the State legislature (Statute 2) in response to the catastrophic losses caused by Event in Year A. The Fund underwrites and issues Event insurance policies in its own name and establishes its own premium rates. Insurers choosing to participate in the Fund (Participating Insurers) will satisfy their legal obligations under Statute 1 by offering a Fund policy for Event coverage. Insurers that do not choose to participate in the Fund will still be required to offer Event coverage independently to comply with Statute 1. Under Statute 2, the Fund is a public instrumentality of State and the exercise of its powers is an essential state governmental function. Premiums collected by the Fund are exempt from the State=s premium tax and federal income tax. Furthermore, amounts held by the Fund shall not be available to meet the general obligations of State. Taxpayer is a Participating Insurer in the Fund.

Under Statute 2, each Participating Insurer is required to execute a contract that sets forth its rights and responsibilities as a Fund participant. Taxpayer executed such a contract (Contract) on Date P. The Contract states that Taxpayer is an independent contractor agent of the Fund, and that Taxpayer is to provide policy services, claims services and all other services required, including underwriting, policy issuance, premium collection, accounting, statistical, data-processing, and records-keeping services. Under the Contract, Taxpayer is entitled to a percentage of the net premium for various services provided. The Contract states that Taxpayer will not assign, transfer or otherwise dispose of any of its rights under the contract.

An Event insurance policy issued by the Fund is only sold to a purchaser who has obtained underlying Type X insurance from a Participating Insurer. Event insurance policies are sold under the name of the Fund and are administered and serviced by the Participating Insurer selling the underlying Type X policy. Taxpayer=s Event insurance policies existing at the time of the Fund=s creation were replaced by Fund insurance

policies at the time of the next policy renewal. Once a Participating Insurer=s existing Event insurance policy is renewed in the name of the Fund, or a new Event policy is written in the name of the Fund, the Fund is required to keep renewing such Event policy as long as a Participating Insurer=s underlying Type X policy is in effect. Coverage under a Fund policy ceases when coverage under the underlying Type X policy ceases.

To participate in the Fund, Participating Insurers are required to contribute an initial assessment to the Fund in an amount proportional to its market share of Event insurance in State as of Date Q. Participating Insurers were generally permitted to make their initial assessment in R monthly installments. Taxpayer contributed $e to the Fund in years B and C as an initial assessment. Taxpayer deducted the initial assessment on its federal income tax returns for years B and C. If funds are inadequate to pay for claims and continuing operations, the Fund may again assess Participating Insurers. Taxpayer=s potential liability for such assessments is $g.

Under Statute 2, the Fund is authorized to acquire reinsurance at a cost not to exceed a reasonable percentage of the annual insurance premiums collected. The Fund acquired reinsurance pursuant to that authority. In addition, under Statute 2, State officials may authorize the issuance of debt obligations that will be repaid through a surcharge on all Event insurance policies issued by the Fund in order to pay claims, if the Fund=s available capital, insurer assessments, reinsurance and other capital committed from private capital markets is insufficient to pay claims. Statute 2 explicitly provides that State has no liability for these obligations.

If all of the above funding sources prove insufficient to cover all claims, the Fund will pay the claims on a pro rata basis or in installment payments. Statute 2 provides that State is not responsible for any liabilities of the Fund. The Fund will at this point cease to write or renew policies, and all Participating Insurers will be required to find another way to satisfy their obligations under Statute 1.

A Participating Insurer may withdraw from the Fund, but the Participating Insurer will not receive any refund of its initial assessment. A Participating Insurer that withdraws from the Fund, but wishes to continue selling Type X insurance policies in State must comply with the requirements of Statute 1 by itself offering Event coverage to its Type X policyholders.

Under Statute 2, if the Fund is terminated by State legislature, its remaining funds are to be transferred to the General Fund of State unless otherwise directed by the legislature.

LAW AND ANALYSIS:

Section 832(c)(1) allows an insurance company a deduction in computing its taxable income of all ordinary and necessary expenses incurred, as provided in section 162 (relating to trade or business expenses).

Section 162(a) generally allows a deduction for all ordinary and necessary expenses paid or incurred during the taxable year in carrying on a trade or business.

Section 263(a) generally provides that no deduction shall be allowed for the cost of permanent improvements or betterments made to increase the value of any property or estate.

Expenditures that are otherwise deductible under section 162 nevertheless are not deductible currently if they are also capitalizable under section 263.

The field argues that Taxpayer=s payment to the Fund is properly capitalized under section 263(a). Taxpayer argues that the payment is deductible currently under section 832(c)(1).

There is no readily available formula for determining in every context whether a particular expenditure is a deductible current expense or a nondeductible capital expenditure. In Welch v. Helvering, 290 U.S. 111, 114 (1933), the Supreme Court observed that Athe decisive distinctions are those of degree and not of kind.@ Courts have employed a variety of standards in making this determination. See. e.g., E.I. du Pont de Nemours & Co. v. United States, 432 F.2d 1052 (3d Cir. 1970) (capital expenditures are those that result in a benefit to the taxpayer which could be expected to produce returns for many years in the future).

In Commissioner v. Lincoln Savings & Loan Association, 403 U.S. 345 (1971), the Supreme Court determined that payments into a secondary reserve fund created a distinct and separate property interest in the secondary reserve and must be capitalized. The taxpayer in Lincoln Savings was a state-chartered savings and loan institution, insured by the Federal Savings and Loan Insurance Corporation (FSLIC). Each insured institution was required by statute to make premium payments which funded a secondary reserve for losses that was only to be used to cover losses to the extent that the primary reserve and other accounts of FSLIC were insufficient. Each insured institution owned a pro rata share of the secondary reserve which was assignable under very limited circumstances and was refundable to the insured if there was a termination of insured status or a liquidation. FSLIC maintained separate accounting for each insured institution=s share of the secondary reserve and submitted to each contributing institution an annual statement disclosing the share amount and interest credited to each institution=s respective account.

In INDOPCO, Inc. v. Commissioner, 503 U.S. 79 (1992), the taxpayer was the target

of a friendly takeover by another corporation. The taxpayer paid an investment banker to evaluate the transaction and render a fairness opinion. The Supreme Court held that the investment banking and legal fees incurred in the takeover must be capitalized. The Court concluded that the takeover would produce significant future benefits to the taxpayer that would extend beyond the end of the taxable year. In discussing its holding in Lincoln Savings, the Court stated

> Lincoln Savings stands for the simple proposition that a taxpayer=s expenditure that serves to create or enhance **Y** a separate and distinct asset should be capitalized under ' 263. It by no means follows, however, that only expenditures that create or enhance separate and distinct assets are to be capitalized under ' 263. **Y** Although the mere presence of an incidental future benefit - >some future aspect= - may not warrant capitalization, a taxpayer=s realization of benefits beyond the year in which the expenditure is incurred is undeniably important in determining whether the appropriate tax treatment is immediate deduction or capitalization. INDOPCO, at 86-87.

We conclude that the initial assessment is not a capital expenditure under section 263(a) of the Code.

In this case, Taxpayer=s payment of the initial assessment to the Fund does not create a separate and distinct asset as was found in Commissioner v. Lincoln Savings. In that case the Supreme Court found certain contributions to a reserve fund to be nondeductible capital expenditures since they created a separate and distinct asset. In making that determination, the Court noted the following four factors. Some of the facts in this case are similar to the facts of Lincoln Savings and some are dissimilar.

(A) In Lincoln Savings, the court found that the secondary reserve payment was subject to positive and rigid continuing controls. The secondary reserve was available only for stated and circumscribed purposes and could be used to pay losses of FSLIC only to the extent the FSLIC=s other assets were not sufficient. The initial assessment paid to the Fund is similar in that it can be used only for specific purposes -- the payment of losses arising from Fund policies and may not be used for other purposes of State.

(B) The Court in Lincoln Savings found that the taxpayer had a distinct and recognized property interest in the Secondary Reserve, revealed by (1) limited transferability in cases of mergers, consolidations and the like, (2) a prospective refund upon termination of insured status, (3) the use of the pro rata share to pay the basic premium when a certain reserve level is reached, (4) maintenance of a separate account for each insured institution=s share, and (5) the statutorily required annual credit from FSLIC=s earnings to the institution=s share of the reserve.

These factors are generally not present in this case:

(1) Transferability. The Fund=s contract states that the taxpayer=s interest in the Fund is not transferable.
(2) Refundability. In this case, there is no refund of the initial assessment.
(3) Use of the pro rata share to pay basic premium. In this case, the initial assessment paid into the Fund can be used only to pay losses on Fund policies.
(4) Maintenance of a separate account. No separate account attributable to each participating company is maintained. The amounts in the fund may only be used to pay losses on Fund policies.
(5) Earning of interest on account. Interest is not credited to Taxpayer=s account. Interest earned on the account must be used to pay losses on policies issued by the Fund. Arguably, interest earned on the account may benefit Taxpayer because it is available for payment of companion policy claims, and because income earned reduces the likelihood of future Fund assessments. However, these benefits are more indirect than the benefit in Lincoln Savings in which interest was credited directly to the taxpayer=s account.

(C) The Court in Lincoln Savings noted that the secondary reserve was designed to provide an insured institution with somewhat permanent protection against future losses by way of segregated amounts to be used to offset such losses. Similarly, the assessments in this case provide a separate pool of funds to be used to pay future losses on Fund policies. However, while Fund policies indirectly benefit Taxpayer because they permit Taxpayer to avoid offering Event coverage directly, Taxpayer does not have a direct liability for Fund policies, and does not have direct liability for the future losses the assessments provide protection against.

While some of the facts in this case are similar to those in Lincoln Savings, we conclude that by virtue of paying the initial assessment and becoming a Participating Insurer, Taxpayer did not create or enhance a separate and distinct asset.

However, in the Supreme Court=s decision in INDOPCO, the Court clarified that the inquiry whether an expense is capitalized goes beyond whether a separate and distinct property interest is created to whether a significant future benefit is realized. Here, we are not convinced that Taxpayer derives a significant future benefit from participation in the Fund.

Taxpayer argues that the initial assessment is deductible because it was paid to preserve and protect its existing Type X business by permitting the taxpayer to terminate unprofitable Event contracts and reduce costs that it was required to incur in connection

with Statute 1.

Generally, amounts paid solely to reduce or eliminate expenses are currently deductible under section 162. Cassatt v. Commissionner, 137 F.2d 745, 749 (3d Cir. 1943). To the extent an expenditure produces long-term benefits in terms of reducing future costs, this is a factor indicating capitalization is appropriate. However, generally this benefit alone is insufficient to require capitalization.

In Rev. Rul. 95-32, 1995-1 C.B. 8, the taxpayer, a public utility company, provided demand-side management (DSM) programs to its customers to promote energy conservation. Under the DSM programs, the taxpayer paid contractors to install low-cost water heating and lighting systems and make energy-saving structural improvements to its customers= houses, and offered rebates for efficient lighting systems to industrial customers. The taxpayer reduced its future operating and capital costs by means of the DSM programs. The revenue ruling concludes that the DSM expenditures are not capital expenditures within the meaning of ' 263, because no asset is created by the expenditures, and Aalthough [the] . . . expenditures may reduce future operating and capital costs, these kinds of benefits, without more, do not require capitalization of these expenditures.@

Similarly, a number of cases have taken the position that amounts paid to secure relief from an unprofitable contract or to reduce costs are deductible currently. Such expenditures reduce a taxpayer=s future expenses and losses, but are deductible, as long as the expenditure is not incident to the purchase of a capital asset or creation of a positive business benefit. Stuart Co. v. Commissioner, 195 F.2d 176 (9th Cir. 1952), aff=g No. 12,473 (T.C. Memo. 1950) (portion of vitamin supplement distributor=s payment allocable to cancellation of an onerous contract to purchase all of its supply requirements from one particular manufacturer); Olympia Harbor Lumber Co. v Commissioner, 30 B.T.A. 114 (1934), aff=d, 79 F.2d 394 (9th Cir., 1935); (payment to eliminate unsatisfactory contract without litigation); Montana Power Co. v. United States, 171 F. Supp. 943 (Ct. Cl. 1959) (a supplier=s payments to cancel a long-term contract); Metrocorp, Inc., v. Commissioner, 116 T.C. 211, 224-225 (2001) (payment of entrance and exist fees to FDIC by bank holding company).

Other cases have held that amounts paid to secure relief from an unprofitable contract must be capitalized if the taxpayer acquires a capital asset incident to the payment. For example, in U.S. Bancorp v. Commissioner, 111 T.C. 231 (1998), the taxpayer had leased a computer for a five-year term, but after a short time, determined that the leased computer was not adequate for its business. It entered into a rollover agreement with the same lessor to lease an upgraded computer and cancel the lease on the original computer. The rollover charge was $2.5 million. The taxpayer deducted that amount in the year the agreement was executed. The Tax Court determined that the

rollover charge should be capitalized as a cost of acquiring the second lease.

In Darlington Hartsville Coca-Cola Bottling Co. v. United States, 393 F.2d 494 (4th Cir. 1968), the taxpayers were Coca-Cola bottling companies. They obtained Coca-Cola syrup from a middleman that charged a higher price than if they bought the syrup directly from Coca-Cola. In order to obtain the syrup more cheaply, they entered into a plan pursuant to which Coca-Cola purchased the stock of the middleman. The taxpayers then reimbursed Coca-Cola for the cost of the stock acquisition. The court determined that the payment was a capital expenditure because its purpose was Ato produce a positive business benefit whose effects will be reaped in seasons beyond a single year.@ However, the court noted that a payment made only to be rid of a burdensome and onerous contract is not per se a capital expenditure.

This case is distinguishable from U.S. Bancorp and Darlington Hartsville Coca-Cola Bottling Co. Taxpayer became a Participating Insurer in the Fund by making the initial assessment, and in so doing met the requirement of Statute 1 to provide Event insurance to its Type X policyholders in State. However the initial assessment was not made incident to the acquisition of a capital asset or acquisition of contract rights that create a significant business benefit extending into future years. Taxpayer=s payment of the initial assessment to the Fund permits it to limit its projected liability that it would otherwise be subject to as the direct issuer of Event insurance policies, however, this benefit is more in the nature of a reduction of future expenses, which, in itself, is not a benefit generally requiring capitalization under section 263. Since the potential cost of issuing Event insurance had increased dramatically, the principal effect of the initial assessment is merely to maintain the status quo, and not to produce a significant future benefit.

Payment of the initial assessment to the Fund should be viewed as a payment which permits the Participating Insurer to satisfy its obligation under Statute 1 at a reduced cost. Taxpayer obtained no other significant right or benefit as a result of payment of the initial assessment that it did not already have. The payment was not a condition to issuing Type X insurance since Taxpayer could have issued Type X insurance without payment of the initial assessment if it had been willing to issue its own Event insurance coverage.

We note that Taxpayer has stated that if the national office makes a determination that the initial assessment is not required to be capitalized under section 263(a), it will treat any portion of the initial assessment that is paid in Year C as incurred in Year C without regard to any application of ' 461(h)(3) and ' 1.461-4(g)(6).

CAVEAT:

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.