INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

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Director
Heavy Manufacturing, Construction & Transportation
Large & Mid-Size Business

Taxpayer's Name:
Taxpayer's Address:

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

LEGEND:

Taxpayer =
Parent =
Payment =
State =
a =
b =
c =
d =
e =
f =
g =
h% =
i% =
j% =
k =
l =
m =
n =
o =
p =
$q =
r =

s	=
t	=
u	=
Year 1	=
Year 2	=
Year 3	=
Year 4	=
Year 5	=
Year 6	=
Year 7	=
Year 8	=
Year 9	=
Year 10	=
Year 11	=
Year 12	=
Year 13	=
Year 14	=
Year 15	=
Month 1	=
Month 2	=
Month 3	=
Month 4	=
Month 5	=
Month 6	=
Month 7	=
Month 8	=
Month 9	=
Date 1	=
Date 2	=
Date 3	=
Date 4	=
Date 5	=
Date 6	=
Date 7	=
Date 8	=
Date 9	=
Date 10	=
Date 11	=
Date 12	=
Date 13	=

ISSUES:

(1) Whether the Payment made by Taxpayer to the State Treasury is deductible under § 162 of the Internal Revenue Code as an ordinary and necessary business expense.

(2) If the Payment is not deductible under § 162, whether the Payment is deductible as a tax under § 164.

(3) Whether the Payment was incurred in Year 14 for purposes of § 461 and the regulations thereunder.

CONCLUSIONS:

(1) The Payment is deductible as an ordinary and necessary business expense under § 162.

(2) Because we have concluded that the Payment is deductible under § 162, we need not address whether the Payment is deductible as a tax under § 164.

(3) The Payment was not incurred by Taxpayer until Year 15.

FACTS:

Background

Parent is a State corporation engaged in the health insurance business through its subsidiaries. Taxpayer is a stock insurance company organized under the laws of State. Prior to Year 15, Taxpayer was known as a, and was a mutual insurance company. Since early Year 15, Taxpayer has been a wholly owned subsidiary of Parent. Taxpayer uses an accrual method of accounting and files its returns on a calendar year basis.

Corporate History

Taxpayer was incorporated in State in Year 1 as a nonstock corporation. Taxpayer is also the successor to a number of other b and c organizations in State. The b organizations were originally formed as hospital service plans providing prepaid hospitalization and the c organizations were originally formed as medical service plans providing prepaid medical services. Eventually, these organizations were combined into one plan serving all of State, except for a small portion of northern State, under a license from d. As used hereinafter, references to Taxpayer include its corporate predecessors.

As did most states, State subjected these organizations to a special regulatory regime. Under this regime, Taxpayer was classified for state regulatory purposes as a “health services plan” rather than as an insurance company. As a health services plan, Taxpayer was regulated under the provisions of the State Code dealing with health rather than as an insurance company under State law. In Year 2, however, “sweep in” legislation subjected Taxpayer to e different insurance company statutes, and subsequent legislation expanded the scope of the sweep in provisions. In Year 6, the health services plan provisions of State law were recodified as part of the insurance

statutes, and thereafter Taxpayer's regulation closely resembled that of an insurance company.

As a result of these changes, Taxpayer concluded that its status as a health services plan hampered its ability to compete with commercial insurance companies. Accordingly, in Month 1 Year 10, Taxpayer converted from a health services plan to a mutual insurance company.

Organization as a Nonprofit

Taxpayer's original articles of incorporation provided that the corporation "is not organized for profit and no dividends shall be declared." The language prohibiting the declaration of dividends was eliminated from the charter in Year 3, while the provision that the corporation was not organized for profit remained. Similar language remained in Taxpayer's charter until Year 7, and was in the charter of Taxpayer's sole member, f, from Year 5 to Month 2 Year 7, and from Month 3 Year 8 until the merger of f into Taxpayer.

From Year 1 to Year 4, the composition of Taxpayer's membership varied, but generally consisted of the participating hospitals and representatives of the community. From Year 4 to Month 4 Year 5, Taxpayer had no members. From Month 4 Year 5 to Month 5 Year 6, Taxpayer's sole member was f. f's charter contained language prohibiting the inurement of its net earnings to any person. In Month 5 Year 6, f changed its name to g; it continued to be the sole member of Taxpayer until Month 9 Year 9, when it merged into Taxpayer. The prohibition on private inurement first appeared in Taxpayer's Amended and Restated Articles of Incorporation dated Date 1.

Following its mutualization transaction in Month 1 Year 10, Taxpayer's policyholders were its members. Taxpayer's articles of incorporation continued to state that Taxpayer was not organized for profit but instead was organized exclusively for the promotion of social welfare within the meaning of § 501(c)(4). In addition, the articles provided that no part of Taxpayer's earnings were to inure for the benefit of any private person.

Tax-Exempt Status

Taxpayer has always been exempt from State income tax (as are all commercial insurance companies). Instead, commercial insurers are subject to a State tax on gross premiums. However, from Year 1 through Year 7, Taxpayer was exempt from this State premium tax.

Commercial insurance companies had long contended that Taxpayer's exemption from the State premium tax gave it an unfair competitive advantage. In Year

6, the u authorized a study to determine whether Taxpayer should continue to retain its exemption from State premium tax. That study concluded that the benefits provided to Taxpayer through the exemption from premium tax exceeded the benefits realized by State and the public, and that Taxpayer should become subject to the premium tax. Therefore, the u enacted legislation subjecting Taxpayer to the premium tax effective Date 2.

Although the u had concluded that Taxpayer should become subject to the gross premium tax, it also recognized that Taxpayer provided certain social benefits and community services that were not provided by commercial insurers. The most significant of these benefits was Taxpayers' maintenance of an "open enrollment" program. Under the open enrollment program, Taxpayer offered to provide health care coverage to any State resident who requested coverage, regardless of health history, employment status, age, or geographical location. Effectively, the open enrollment program made Taxpayer the health insurer of last resort in State.

As an inducement to Taxpayer to continue the open enrollment coverage, the u provided that Taxpayer's premium tax rate would be h% (rather than the standard i% rate) for as long as Taxpayer maintained its open enrollment program. This rate reduction was intended to offset the losses Taxpayer habitually incurred on the open enrollment program. The legislation provided for continued monitoring of the open enrollment program to ensure that the benefits provided through the reduced premium tax rate did not exceed the net losses incurred by Taxpayer on the open enrollment program.

Since Year 8, Taxpayer's premium tax liability has increased. The u enacted legislation requiring all health insurance companies to offer coverage to small groups. As part of that change, Taxpayer became subject to the full premium tax rate on premiums paid by small groups. In Year 1, the u changed the law to require Taxpayer to pay the j%[1] rate on all group insurance premiums. Thus, Taxpayer continues to receive the reduced premium tax rate of h% only with respect to individual health insurance policies, which is the only market in which Taxpayer is the only insurer required by State law to accept all business.

Negotiations with the k

Because of the rapid pace of change taking place in the health insurance industry, which required large investments for systems development and expansion, Taxpayer's management eventually reached the conclusion that Taxpayer needed better access to the capital markets. Taxpayer's status as a mutual insurance company

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[1] When Taxpayer first became subject to the premium tax in Year 8, the standard premium tax rate was i%. When Taxpayer became subject to the full premium tax in Year 1 on all group insurance, the rate had declined to j%.

did not provide it with access to the equity markets. Therefore, in Year 11 Taxpayer began to consider the possibility of converting from a mutual insurance company to a stock insurance company.

In Year 12, Taxpayer began to meet with representatives of the k of the l to explore the possibility of a demutualization in which Taxpayer would become a stock insurance company. A variety of possibilities were discussed with the k, including transactions in which Taxpayer would contribute operating assets to a for-profit subsidiary that would issue stock in a public offering and the formation of a stock holding company to acquire all of the membership interests in Taxpayer.

Ultimately, Taxpayer proposed a transaction in which it would create a new holding company ("Holding"), Holding would create a new subsidiary ("Interim"), and Interim would merge with and into Taxpayer, with Taxpayer surviving as a stock corporation and first-tier subsidiary of Holding. Pursuant to this plan, Taxpayer's members would receive cash and/or common stock of Holding. Taxpayer and the k began an informal review process that explored Taxpayer's proposal. The k retained legal, accounting, tax, and actuarial experts (at Taxpayer's expense) to assist in analyzing the various issues to be considered by the l in connection with the proposal.[2] Taxpayer and the k and their respective advisors concluded that the demutualization was permissible under State Code section m, which permitted a mutual insurance company to convert to a stock insurance company pursuant to a plan of conversion approved by the l. In addition, section n, which had been enacted in Year 10 to authorize the conversion of Taxpayer from a health services plan to a mutual insurance company, specifically contemplated the possibility of a subsequent conversion to a stock insurance company. Because it was a mutual insurance company whose members were its policyholders, Taxpayer took the position in its meetings with the k that Taxpayers' policyholders were its owners and therefore were entitled to the stock and cash distributed upon demutualization.

Taxpayer and the k were aware that a number of other similar organizations were considering or had undertaken transactions to obtain access to the capital markets. These transactions had generated debate over the nature of these organizations and how the transactions should be treated.

On Date 3, Taxpayer filed an application with the l to convert from a nonstock, not-for-profit mutual insurance company to a for-profit stock corporation (the Month 6 Year 13 Application). The Month 6 Year 13 Application was filed with the l on the basis of Sections m and o of the Code of State, 1950, as amended. Section m of the State Code provided that

Section o required the approval of the plan by the l before the plan could

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[2] Taxpayer reimbursed the k for its costs in connection with the demutualization and Taxpayer has capitalized those costs for tax purposes.

be submitted to the stockholders or members, and provided that approval of the I could be granted only if, after a hearing, the I determined that the plan of merger is "fair, equitable, consistent with law, and that no reasonable objection to the plan exists."

Negotiations with the s

In a letter dated Date 4, the s of State notified the I of his intention to participate in the demutualization proceeding. In a subsequent letter dated Date 5, the t of State identified several fundamental issues raised by the Month 6 Year 13 Application, noting that

In a subsequent letter to counsel for Taxpayer, the t elaborated further on the "principal legal issues" raised by the Month 6 Year 13 Application. First, the t contended that although the State Code permitted the merger of a nonstock corporation into a stock corporation, it was possible that the distribution of stock and cash to members in the merger would violate other provisions of the Code prohibiting the distribution of earnings by a nonstock corporation. Second, the t asserted that

The t further stated:

Accordingly, the t asserted, under State law it was possible that the doctrines of cy pres, equitable approximation, or constructive trust would require all or some portion of Taxpayer's assets to be distributed to the public before a merger and distribution of cash/stock to eligible members.

Following the announcement by the s of his intention to intervene in the proceedings, Taxpayer began negotiations with the s over the possibility of a settlement pursuant to which Taxpayer would make a payment in satisfaction of any potential claims that could be made against it by reason of its prior status as a non-profit or "public benefit" corporation. In its analysis of a potential settlement, the s drew a distinction between two forms of nonstock corporations: charities, which are organized exclusively for public benefit, and commercial or for-profit entities. The legal advisor to the s later described the s's position as follows:

The s thus took the position that Taxpayer was a hybrid between a mutual benefit corporation, whose assets are equitably owned by its members, and a public benefit corporation, whose assets must be devoted to charitable or public purposes.

After extensive negotiations, in Month 7 Year 13 Taxpayer and the s reached an agreement pursuant to which Taxpayer would be required to make a payment equal to its surplus as of Date 6, the last day prior to its becoming subject to the State premium tax. The rationale behind this agreement was articulated by the legal advisor to the s:

The agreement with the s contemplated that this payment be made to a new charitable foundation, the purpose of which would be to provide medical care for the poor and to provide other charitable activities.

Having reached an agreement with the s, Taxpayer filed a revised Application (the "Month 4 Year 14 Application") seeking approval of the demutualization transaction under the provisions of State law authorizing the merger of nonstock corporations into stock corporations, and the provision of the State Insurance Code relied on in its Month 6 Year 13 Application.

State Legislation

Although the I had authority under State law to approve the demutualization transaction, State law was not clear on the portion of Taxpayer's assets that were dedicated to public purposes. Despite the agreement with the s, some persons continued to take the position that, because of Taxpayer's organization as a tax-exempt, not-for-profit corporation, it should be required to devote all of its assets to charitable purposes. Taxpayer was concerned that these persons might challenge the revised plan before the I or, following approval of the plan by the I, might appeal the I's decision to the State Supreme Court. In addition to uncertainty over the size of the charitable payment it might ultimately be required to make, Taxpayer was concerned that such a challenge could take several years to resolve, during which time it would be unable to proceed with the demutualization.

Second, Taxpayer was seeking confirmation from the federal Securities and Exchange Commission (SEC) that the issuance of Parent stock in the demutualization was exempt from federal securities registration requirements by virtue of section 3(a)(10) of the Securities Act of 1933. Under that section, an exemption from federal registration was available, provided that the issuance was the subject of a fairness hearing at the state level. Based on conversations between Taxpayer's advisors and SEC staff, it was unclear whether the SEC would agree that the provisions of State law applicable to the merger of a nonstock corporation into a stock corporation would satisfy the SEC's requirement of a fairness hearing at the state level. Although failure to satisfy that requirement would not have precluded the transaction from occurring, it could have delayed the transaction for several months and increased the expense of the transaction.

For these reasons, Taxpayer concluded that state legislation confirming its settlement with the s would be advisable. Accordingly, amid considerable public interest, Taxpayer began to seek enactment of legislation in the u to facilitate its conversion to a for-profit stock corporation.

As finally enacted, section p of the Code of State modified and codified the settlement with the s. Section p reads as follows:

During the process of considering this legislation, the concept of the payment from Taxpayer going into a trust was replaced by a direct payment to State. The payment amount agreed to by the s was incorporated in the legislation. However, several legislators insisted that this amount should be adjusted to the "present value" of the Date 6 surplus figures. Although there is no formal legislative history for this provision, several members of the u indicated that the $q increase in the state payment was intended to represent "interest" on the stated surplus.

State Code section p was enacted by the u and signed by the Governor of State. Shortly after the statute was enacted, Taxpayer filed a revised application for approval of its demutualization plan and requested that the plan be considered at a l hearing. The policyholders of Taxpayer approved the plan to demutualize at a special meeting on Date 7. The l began public hearings on Date 8 to determine whether any policyholder's interest would be harmed as a result of the demutualization and issued its ruling approving the transaction in Month 8 Year 14. Taxpayer prepared an amended plan incorporating certain changes required by the l and filed it with the l on Date 9. The l approved the amended plan on Date 10.

Based on the provisions of the statute pertaining to the fairness hearing, the SEC issued a no-action letter under section 3(a)(10) of the Securities Act of 1933 on Date 11.

The demutualization was effected through the creation of a new holding company, Parent. A newly formed subsidiary of Parent, r, merged with and into Taxpayer effective Date 12. The reorganization and an initial public offering of Parent stock closed on Date 12, and the Payment was paid to the State Treasury on Date 13. Taxpayer deducted the Payment in Year 14 for financial accounting purposes and federal income tax purposes.

LAW AND ANALYSIS OF ISSUE (1):

Taxpayer argues that the Payment is deductible as an ordinary and necessary business expense under § 162, while the revenue agent argues that the Payment must be capitalized under § 263. Section 162(a) allows a deduction for all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business. See also § 1.162-1(a) of the Income Tax Regulations. Section 263(a), however, prohibits a deduction for any amount paid out for new buildings or for permanent improvements or betterments made to increase the value of any property or estate. See also § 1.263(a)-1(a). Section 161 provides that there are allowed as deductions the items specified in Part VI (which contains § 162), subject to the

exceptions provided in Part IX (which contains § 263). Through provisions such as §§ 162 and 263, the Code endeavors to match expenses with the revenues of the taxable period to which they are properly attributable, thereby resulting in a more accurate calculation of net income. INDOPCO, Inc. v. Commissioner, 503 U.S. 79, 84 (1992).

The determination of whether an expenditure is capital or deductible is based on a careful examination of the particular facts and circumstances of each situation. Deputy v. du Pont, 308 U.S. 488, 496 (1940). In the instant case, the nature of the payment as capital or deductible is determined under the "origin of the claim" doctrine established by the Supreme Court in United States v. Gilmore, 372 U.S. 39 (1963).[3] See Anchor Coupling Co. v. United States, 427 F.2d 429, 433 (7th Cir. 1970). This doctrine provides that the origin and character of a claim, rather than its consequence or result to the taxpayer, determine the deductibility of the related expenditure. Gilmore, 372 U.S. at 49. The doctrine does not contemplate a mechanical search for the first in the chain of events which led to the expenditure but, rather, requires an examination of all the facts to determine the transaction or activity from which the expenditure proximately resulted. Boagni v. Commissioner, 59 T.C. 708, 713 (1973), acq., 1973-2 C.B. 1.

Taxpayer contends that the Payment is deductible under the origin of the claim doctrine because the claim to which the Payment relates is Taxpayer's prior status as a nonprofit, tax-exempt corporation. The revenue agent argues that the Payment should be capitalized because the origin of the Payment was Taxpayer's desire to demutualize in order to increase its capitalization. Expenditures incurred to increase a corporation's capitalization are capital in nature. See Fishing Tackle Products Co. v. Commissioner, 27 T.C. 638 (1957); Motion Picture Capital Corporation v. Commissioner, 80 F.2d 872 (2d Cir. 1936); Skenandoa Rayon Corporation v. Commissioner, 122 F.2d 268 (2d Cir. 1941). See also INDOPCO, 503 U.S. 79; General Bancshares Corp. v. Commissioner, 326 F.2d 712 (8th Cir. 1964) (expenditures incurred to change a taxpayer's corporate structure for the benefit of future operations are capital expenditures). In addition, expenditures that provide a taxpayer with significant future benefits must be capitalized. INDOPCO, 503 U.S. at 87.

The agent argues there is a clear connection between the Payment and the Taxpayer's demutualization and, thus, the Payment should be capitalized as a cost of the demutualization. We agree with the agent that costs incurred by Taxpayer to demutualize must be capitalized under the authorities cited above. In fact, Taxpayer capitalized the costs it incurred to reimburse the k for its costs in connection with the

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[3] The revenue agent asserts that the origin of the claim doctrine is limited to situations where some sort of claim or litigation exists and the taxpayer has incurred expenditures with respect to that claim or litigation. In response, Taxpayer asserts, in part that the Payment did arise from a "claim" against Taxpayer by reason of its historical status as a nonprofit corporation and its prior exemption from State premium tax. We agree with Taxpayer's assertion regarding the origin of the claim doctrine and believe the origin of the claim doctrine is applicable in this case.

demutualization. A deductible expenditure, however, does not become a capital expenditure simply because of some relation in time or circumstance to a capital transaction. See Connecticut Light and Power Co. v. United States, 299 F.2d 259, 264 (Ct. Cl. 1962). Instead, under the origin of the claim doctrine, the issue in the instant case is whether the origin of the claim to which the Payment relates is the demutualization, as the agent asserts, or Taxpayer's prior status as a nonprofit, tax-exempt corporation, as Taxpayer asserts.

The Service has recognized that payments to satisfy claims or obligations originating in the ordinary course of a taxpayer's business may be deducted, even though payments to satisfy those claims or obligations are triggered by a capital transaction. For example, in Rev. Rul. 73-146, 1973-1 C.B. 61, the Service considered whether payments to employees to terminate their unexercised stock options were deductible in a situation where the payments were required as a condition to a reorganization. The Service held that the payments were deductible because the obligation to make the payments arose from the employer's pre-existing employment relationship with the employees and not the reorganization itself. Thus, under the origin of the claim doctrine the payments were ordinary expenses, even though the obligation to make the payments was triggered by a capital transaction. Similarly, the Service has recognized that severance payments to former employees of a railroad following its merger into another railroad are deductible where the acquired railroad became obligated to make severance payments to employees affected by the merger. See Rev. Rul. 67-408, 1967-2 C.B. 84. Again, the origin of the claim to which the payments related was the ordinary employment relationship between the employees and the taxpayer incurring the liability.

In each of the revenue rulings, the claim arose from the ordinary course of the taxpayer's business and existed independently of the capital transaction. Even though payment of the claim might not have been made but for the capital transaction, the payments were deductible as ordinary and necessary business expenses. The revenue rulings also demonstrate that the appropriate inquiry is to examine the origin of the underlying claim or obligation, and not the origin of the payment itself. In each ruling, the origin of the payment might have been the capital transaction (as the triggering event for payment of the underlying claim or obligation), but the origin of the claim or obligation was the ordinary course of the taxpayer's business.

In the instant case, the Payment made by Taxpayer to the State Treasury is similar to the payments at issue in the revenue rulings. Thus, the first inquiry is to determine the origin of the underlying claim or obligation to which the Payment related. Taxpayer asserts that its underlying obligation to make the Payment originated from its nonprofit, tax-exempt status in State. Taxpayer argues that this status gave rise to certain claims or obligations that State could assert under the cy pres doctrine, constructive trust doctrine, or similar doctrine, for the benefit of the public. In contrast, the revenue agent asserts that Taxpayer had no pre-existing legal obligation to make the Payment to State. Based on the facts and circumstances that led up to the Payment, we agree with Taxpayer. Although Taxpayer was not required to make the

Payment prior to its demutualization, the s of State clearly believed that Taxpayer's status as a nonprofit, tax-exempt corporation prior to the demutualization obligated Taxpayer to dedicate some or all of its assets for the benefit of the public. The s contended that Taxpayer was subject to claims by State because some of its cash surplus had been derived from the tax exempt and tax advantaged status as well as the not-for-profit status that it had enjoyed from State since its formation. A careful analysis of these assertions by the s throughout the demutualization process demonstrate that the underlying claims against Taxpayer existed prior to, and independently of, the demutualization. Because the origin of the underlying claim to make the Payment was Taxpayer's nonprofit, tax-exempt status, we conclude that the Payment arose from the ordinary course of Taxpayer's business and not from the demutualization.

The revenue agent also argues that the Payment was a "toll charge" for the right to demutualize and thus, provided significant long-term benefits to Taxpayer. See INDOPCO, 503 U.S. at 87 ("[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"). The agent argues that Taxpayer wanted to demutualize and that the State Code required the Payment in order to accomplish that objective. After considering the facts and circumstances of the instant case, we do not think the Payment provided Taxpayer with a significant long-term benefit. Although the legislation, on its face, arguably imposes a "toll charge" for Taxpayer to demutualize, we have already concluded that the origin of the obligation to pay the "toll charge" arose from Taxpayer's prior nonprofit, tax-exempt status. Thus, the Payment is similar to settlement payments that are incurred by taxpayers to extinguish existing liabilities. For example, in Rev. Rul. 79-208, 1979-2 C.B. 79, the Service held that an amount paid by the taxpayer to settle a lawsuit and obtain a release from all claims under a franchise agreement were deductible under § 162. The Service noted that the litigated claim arose after the taxpayer breached the franchise agreement by operating the franchise without paying the monthly fees required by the agreement. Under the origin of the claim doctrine, the settlement payment originated in the taxpayer's operation of the franchise and, thus, was deductible as an ordinary and necessary business expense. The facts in the instant case indicate that the Payment was made in order to discharge the pre-existing claims arising from Taxpayer's status as a nonprofit, tax-exempt corporation. The release of these pre-existing claims relates to Taxpayer's prior status and does not provide Taxpayer with a significant future benefit. Further, there is no indication in any of the facts presented that the s or the State u was concerned about claims arising from Taxpayer's future operations as a stock insurance company. Thus, there is no need to capitalize the Payment in order to match it with revenues from Taxpayer's operations after the demutualization.

Although we have determined that the origin of the Payment was not Taxpayer's demutualization and that the Payment did not provide Taxpayer with significant future benefits, the payment must also be "ordinary" and "necessary" to be deductible under § 162. The term "necessary" means appropriate and helpful to the development of the taxpayer's business. Commissioner v. Tellier, 383 U.S. 687, 689 (1966); Commissioner v. Heininger, 320 U.S. 467, 471 (1943); Welch v. Helvering, 290 U.S. 111, 113 (1933).

The Payment meets this test; it was appropriate and helpful to the development, and even continuation, of Taxpayer's business. The s had the authority to enforce Taxpayer's obligation to the public through the cy pres doctrine, the constructive trust doctrine, or other similar doctrines, and used that authority to ensure that Taxpayer compensated the public for its prior status as a nonprofit, tax-exempt corporation. Taxpayer could reasonable believe that its failure to satisfy the s by making the Payment could result in substantial harm to its business operations. Thus, the Payment was necessary.

The Payment is also "ordinary" under the specific facts of this case. In defining "ordinary," the Supreme Court has stated:

> What is ordinary, though there must always be a strain of constancy within it, is none the less a variable affected by time and place and circumstance. One of the extremely relevant circumstances is the nature and scope of the particular business out of which the expense in question accrued. The fact that an obligation to pay has arisen is not sufficient. It is the kind of transaction out of which the obligation arose and its normalcy in the particular business which are crucial and controlling.

Du Pont, 308 U.S. at 496 (citing, in part, Welch, 290 U.S. at 113-114). Thus, the Court in du Pont looked to the kind of transaction out of which the obligation arose to determine whether the expenditure at issue was "ordinary." In the instant case, we have already determined that the origin of the Payment was Taxpayer's nonprofit, tax-exempt status, and not the demutualization. Thus, under the particular facts and circumstances of this case, the Payment was an ordinary and necessary business expense and is deductible under § 162.

LAW AND ANALYSIS OF ISSUE (2):

Because we have concluded that the Payment is deductible under § 162 as an ordinary and necessary business expense, we need not address whether the Payment is deductible as a tax under § 164.

LAW AND ANALYSIS OF ISSUE (3):

Taxpayer argues that the Payment was incurred in Year 14 under § 461 and the regulations thereunder. Section 461 provides that the amount of any deduction or credit allowed by subtitle A is taken for the taxable year that is the proper taxable year under the method of accounting used in computing taxable income. Section 1.461-1(a)(2) provides that, under an accrual method of accounting, a liability is incurred, and generally is taken into account for federal income tax purposes, in the taxable year in which all the events have occurred that establish the fact of the liability, the amount of the liability can be determined with reasonable accuracy, and economic performance has occurred with respect to the liability.

With regard to the Payment, Taxpayer argues that in Year 14 all the events had occurred to establish the fact of the liability, the amount of the liability could be determined with reasonable accuracy, and economic performance had occurred with respect to the liability. We agree with Taxpayer that all the events had occurred to establish the fact of the liability in Year 14. In Year 14, Taxpayer's plan to demutualize was approved by Taxpayer's policyholders and the I. These events established the fact of Taxpayer's liability in Year 14. We also agree that Taxpayer's liability could be determined with reasonable accuracy in Year 14. The amount of the Payment was equal to Taxpayer's surplus, computed in accordance with generally accepted accounting principles, on Date 6, plus $q. Thus, the amount of the payment was readily determinable in Year 14.

With regard to economic performance, Taxpayer argues that its liability for the Payment meets the economic performance requirements in Year 14 under the recurring item exception of § 461(h)(3). Taxpayer asserts that the Payment is a liability to pay a rebate, refund, or similar payment. Section 1.461-4(g)(3) provides that if the liability of a taxpayer is to pay a rebate, refund, or similar payment to another person (whether paid in property, money, or as a reduction in the price of goods or services to be provided in the future by the taxpayer), economic performance occurs as payment is made to the person to which the liability is owed.

Section 461(h)(3) provides an exception to the economic performance rules for certain recurring items. See also § 1.461-5. Under the recurring item exception, a liability is treated as incurred for a taxable year if –

(1) As of the end of that taxable year, all events have occurred that establish the fact of the liability and the amount of the liability can be determined with reasonable accuracy;
(2) Economic performance with respect to the item occurs on or before the earlier of –
    (a) The date the taxpayer files a timely (including extensions) return for that taxable year; or
    (b) The 15th day of the 9th calendar month after the close of the taxable year;
(3) The liability is recurring in nature; and either –
    (a) The amount of the liability is not material; or
    (b) The accrual of the liability for that taxable year results in a better matching of the liability with the income to which it relates than would result from accruing the liability for the taxable year in which economic performance occurs.

Section 1.461-5(b)(1). Section 1.461-5(b)(5)(ii) provides, in part, that in the case of a liability described in paragraph (g)(3) (rebates and refunds), the matching requirement of § 1.461-5(b)(1)(iv)(B) is deemed to be satisfied.

We disagree with Taxpayer's contention that the Payment is a rebate subject to the recurring item exception. First, we do not agree that the Payment is properly characterized as a rebate, refund, or similar payment, despite Taxpayer's assertion that the Payment "should qualify as a rebate or refund liability with respect to the surplus generated by the revenues received while [Taxpayer] was exempt from state premium tax." There is no evidence that the Payment was a rebate or refund of any specific payment previously made by State to Taxpayer. The fact that Taxpayer previously was exempt from state premium tax and, thus, was able to retain more of its revenues, does not indicate any type of payment by State to Taxpayer that was later given back to State, in part or in full, through the Payment.

Because the Payment is not a rebate or refund, the economic performance rules of § 1.461-4(g)(7) apply. Section 1.461-4(g)(7) provides that, in the case of a taxpayer's liability for which economic performance rules are not provided elsewhere in this section or in any other Internal Revenue regulation, revenue ruling or revenue procedure, economic performance occurs as the taxpayer makes payments in satisfaction of the liability to the person to which the liability is owed. Paragraph (g)(7) applies only if the liability cannot properly be characterized as a liability covered by rules provided elsewhere in this section. Section 1.461-5(c) provides, in part, that the recurring item exception does not apply to any liability of a taxpayer described in paragraph (g)(7) (other liabilities) of § 1.461-4. Thus, the recurring item exception does not apply to the Payment, and economic performance occurs when the Payment is made in satisfaction of the liability to the person to which the liability is owed (the State Treasury), which occurred in Year 15.

In addition, even if the Payment were a rebate or refund liability, this liability is not recurring in nature.[4] Section 1.461-5(b)(3) provides that a liability is recurring if it can generally be expected to be incurred from one taxable year to the next. However, a taxpayer may treat a liability as recurring in nature even if it is not incurred by the taxpayer in each taxable year, and a liability that has never previously been incurred by a taxpayer may be treated as recurring if it is reasonable to expect that the liability will be incurred on a recurring basis in the future. Section 1.461-5(b)(3). In this case, the liability is not expected to be incurred from one taxable year to the next and it is not reasonable to expect that the liability will be incurred on a recurring basis in the future. In fact, Taxpayer states in its submission that the Payment discharged any claims that State may have been able to assert against Taxpayer in the future. Thus, the purpose of the Payment was to prevent this type of liability from recurring. Accordingly, the liability of Taxpayer to make the Payment is not recurring in nature.

CAVEAT(S)

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

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[4] We note that, even if we had considered the issue and determined that the Payment was a tax under § 164, the Payment would not be a recurring item.