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INTERNAL REVENUE SERVICE
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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR AREA COUNSEL (LMSB) COMMUNICATIONS, TECHNOLOGY AND MEDIA

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CC:FIP

SUBJECT: TL-N-2978-01

This memorandum constitutes Chief Counsel Advice. In accordance with § 6110(k)(3), this Chief Counsel Advice should not be cited as precedent.

LEGEND

Taxpayer =

IC =

Year 1 =

Year 7 =

Year 10 =

Year 12 =

Year 21 =

Year 22 =

Year 23 =

Year 24 =

State A =

State B =

State C =

State D =

State E =

State F =

State G =

State H =

State I =

State J =

m =

n =

o =

p =

r =

x =

ISSUES:

(1) Whether a transaction by which a self-insured company retroactively insures "known" losses arising under workers' compensation acts constitutes insurance for federal income tax purposes?

(2) Assuming the transaction does not constitute insurance for federal income tax purposes, when does economic performance occur with regard to the "premium" payments made by the company?

CONCLUSIONS:

(1) Additional factual development is needed to determine whether the transaction is an insurance transaction.

(2) Assuming, however, that the transaction is not an insurance transaction, economic performance occurs as payments are received by the claimants.

FACTS:

Taxpayer is a State A corporation engaged in the business of providing m services. With some exceptions noted below, for the period January 1 of Year 1 through April 1 of Year 22, Taxpayer was permissibly self-insured for workers' compensation benefits in the States of B, C, D, E, F, G, H and I.[1]

For the period beginning on January 1 of Year 1 through April 1 of Year 22, Taxpayer, purchased specific excess policies from unrelated commercial insurance carriers. In the early years of this period, Taxpayer typically retained as its own workers' compensation obligation the first $1 million per "incident" and insured with commercial carriers the range between $1 million to $3 million. Beginning in Year 7, coverage under the specific excess policies increased and divided into two elements: workers' compensation Coverage A and workers' compensation Coverage B. Coverage A involves an agreement under which an insurance company promises to pay all compensation and all benefits required of an insured employer under the workers' compensation act of the state or states listed in the policy. Coverage B often provided for situations in which an employee not covered under workers' compensation laws could sue for injuries suffered under common law liability. During this later period of time, the excess insurers provided unlimited coverage up to the statutory limit of the states involved, and the limits on Coverage B ranged from $1 million to $5 million.[2] We understand that the specific excess policies were not subject to an aggregate policy limit. Also limiting Taxpayer's workers' compensation obligations are state statutes that provide for the reduction of the employer's workers' compensation payment obligation to the extent necessary to avoid diminution of the federal Social Security disability insurance payments. See e.g., § n of the State E Labor Code.

On March 24 of Year 22, Taxpayer was issued a binder on the letterhead of o insurance broker indicating that for certain premiums IC, a State J insurer, would reimburse Taxpayer for losses and allocated loss adjustment expenses paid between November 30 of Year 21 and May 1 of Year 22 for losses occurring prior to April 1 of Year 22. In the binder, two premiums were stated to be $40,970x for the period of January 1 of Year 1 to January 1 of Year 22, and $1,856x for the period January 1 of Year 22 to April 1 of Year 22, for a total of $42,826x. (The binder states that the effective date was May 1, for losses occurring between January 1 Year 1 and April 1 of Year 22.) An invoice of the o insurance broker dated April 23 of Year 22 recites the amount of $37,470x and a credit of $5,356x, which totals $42,826x.

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[1] On February 21 of Year 10 and January 1 of Year 12, respectively, Taxpayer ceased being self insured in State G and D, respectively. For purposes of this memorandum, it is assumed that subsequent to February 21 of year 10 and January 1 of Year 12 with respect to its operations in State G and State D, respectively, Taxpayer was insured by another insurance carrier or, alternatively, discontinued the kind of operations that require it to provide a workers' compensation program in those states.

[2] We are uncertain as to whether Taxpayer had any coverage during the period August 15 of Year 9 and January 1 of Year 16.

During Year 23, Taxpayer and IC applied to the Department of Industrial Relations of State B for permission to release Taxpayer from its obligations under the State B statutes as a self insurer and pursuant to p of the state statute. The parties presented to the State B Industrial Relations Department a document entitled "special excess workers compensation and employers liability policy declarations." On December 13 of Year 23, the Department approved the release of Taxpayer's obligations as a self-insurer and the substitution of IC's obligations in lieu thereof with a policy effective date of October 1 of Year 23.[3] (Taxpayer's representatives represent they do not know whether Taxpayer has received any comparable state approvals from the other states.)

On June 14 of Year 24, Taxpayer and IC signed two assumption agreements. One dealt with the transfer of Taxpayer's workers' compensation obligations to IC with respect to State B and the other dealt with the transfer of Taxpayer's workers' compensation liabilities to IC concerning the other states that Taxpayer currently operated in or formerly operated in.

The assumption agreements recite that IC is fully qualified to handle workers' compensation claims under the laws of the involved states, including reporting and claims payment. The agreements further recite that IC is willing to assume certain of Taxpayer's unpaid liabilities and obligations under the workers' compensation laws of the involved states and to assume certain employers' liability, and to hold Taxpayer, its respective successors, transferees, affiliates and assignees, free of claims and liabilities thereunder up to aggregate limits specified therein.

The assumption agreement with respect to State B provided for a stated cash consideration of $17,130x and the assumption agreement with respect to the other states provided for a cash consideration of $25,696x. Other than the cash consideration, the only other amounts stated in the assumption agreements are a self-insurer deposit for State B at $29,558x and a self-insurer deposit for the remaining states at $33,443x. The agreements provide that the total principal amount of any surety bond or other collateral, together with all payments made by IC, shall not exceed $29,558x and $33,443x, respectively. There is some ambiguity as to whether these figures provide an aggregate limit on the respective policies or are merely a reference to the surety bond requirements; that view of the facts is inconsistent with the recitation that the policies contain an aggregate limit of IC's liability.[4] The assumption

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[3] October 1 of Year 23 is the date that Taxpayer as a policyholder of IC was granted coverage under the State B guarantee fund, which provides certain benefits.

[4] There are a number of other inconsistences between the assumption agreement and the previously described document approved by the State B Industrial Relations Department on December 12 of Year 23. While the document submitted to the State B Department was in the form of an insurance policy and approved by the Department as such, the assumption agreement unequivocally states that the assumption agreement is not and shall not be interpreted as a contract of insurance.

agreements assign to IC all of Taxpayer's rights to any salvage and subrogation arising out of its workers' compensation claims incurred while Taxpayer was self insured. Taxpayer also assigned to IC all of the existing specific excess policies that Taxpayer had in effect during the period January 1 of Year 1 through April 1 of Year 22.

The assumption agreements recite that Taxpayer acknowledges that the agreements do not relieve Taxpayer of its statutory obligations as a self-insurer and acknowledges that Taxpayer will still file, or assist IC in filing, required statutory reports on Taxpayer's behalf.

LAW AND ANALYSIS:

Issue 1

Generally, premiums paid for insurance are deductible under § 162(a) of the Internal Revenue Code if directly connected with a taxpayer's trade or business. Section 1.162-1(a) of the Income Tax Regulations. Although the Internal Revenue Code does not define the term "insurance," the United States Supreme Court has explained that to constitute "insurance," a transaction must involve "risk shifting" (from the insured to the insurer) and "risk distribution" (by the insurer). Helvering v. LeGierse, 312 U.S. 531, 539 (1941). A similar standard has been used both for exemption from federal antitrust laws, see Group Health Life Insurance Co. v. Royal Drug Co., 440 U.S. 205, 211 (1979) ("The primary elements of an insurance contract are the spreading and underwriting of a policyholders's risk."), and for federal securities laws, see Securities and Exchange Commissioner v. Variable Life Insurance Co., 359 U.S. 65 (1959). Moreover, the opinions in SEC v. United Benefit Life Ins. Co., 387 U.S. 202, 211 (1967), and in LeGierse, 312 U.S. at 542, indicate that the transfer of an investment risk cannot by itself create insurance. More recently, a series of cases in the captive insurance company area have provided a 3-prong test : (1) whether the arrangement involves the existence of an "insurance risk," (2) whether there was both risk shifting and risk distribution; and (3) whether the arrangement was for "insurance" in its commonly accepted sense. See e.g., Harper Group and Subsidiaries v. Commissioner, 96 T.C, 45 (1991), aff'd. 979 F.2d 1341 (9^{th} Cir. 1992).

In Rev. Rul. 89-96, 1989-2 C.B. 114, a business incurred a liability substantially in excess of $130x to injured persons as a result of a catastrophe that occurred in June 1987. The business' existing liability coverage at the time totaled $30x. In July 1987, the business entered into a contract with a casualty insurance company for additional "liability insurance" in the amount of $100x. The premium for this "insurance" was $50x. In exchange, the insurance company promised to pay (subject to the contract limit of $100x) those sums in excess of $30x for which the taxpayer would become legally liable to pay as damages as a result of the catastrophe. Economically, it was expected that the amount of the net premium received by the insurance company, plus the tax benefit of the deduction for losses incurred, plus the investment income on those amounts, would exceed the possibly maximum anticipated liability of $100x under its contract with the business. The ruling concludes that the arrangement does not involve the requisite risk shifting necessary for insurance. The risk event had already occurred;

the losses were reasonably expected to far exceed the contract's limit of $100x; and, the risks transferred were in the nature of investment risk, not insurance risk.

We believe that the analysis of Rev. Rul. 89-96 has equal application to the purchaser of such a contract. Additional factual development is warranted before applying that analysis in the present case.

We believe that actuarial assistance would be necessary to quantify the liability shifted to IC, and consider all of the relevant factors involved in the case, including the protections that IC has secured from the existing policies, statutes of limitations,[5] other limitations, federal disability benefits and the deaths of covered workers. (You should secure from Taxpayer true copies the existing specific excess polices that were issued to Taxpayer during the period of its self insurance and assigned to IC.) In our view the appropriate legal standard for measuring IC's effective cap would be based on reasonable expectations, and not on the theoretical maximum liability that might apply if everything that could go wrong went wrong. See Winn-Dixie Stores, Inc. & Subs. v. Commissioner, 113 T.C. 254, 284-285 (1999), aff'd 254 F. 3rd 1313 (11th Cir. 2001).[6]

You may also consider whether the arrangement was "for 'insurance' in its commonly accepted sense" (Harper at 58) by focusing upon how the transaction was treated at the insurance company level. For example, did IC treat this transaction as insurance by (1) paying the appropriate premium tax, (2) paying the appropriate assessments to the respective state guarantee funds, and (3) treating the amounts received as premium income on its NAIC annual statement filed with the State J insurance regulator?[7] Arrangements that do not present a significant risk of

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[5] We note that some workers' compensation statutes applicable to this case bar certain claims in as short a period as one year (section r of the State G Labor and Industrial Relations Code).

[6] In Winn-Dixie, the taxpayer unsuccessfully defended the claimed economic substance and business purpose of its leveraged corporate-owned life insurance program (COLI) by suggesting that the block of life insurance policies could conceivably require payment of large, unexpected death benefits. The Tax Court dismissed this argument stating that it "was convinced that this was so improbable as to be unrealistic and therefore had no economic significance."

[7] A principle that has emerged from the treatment of property and casualty reinsurance and applicable in theory to primary coverage is that "[i]t must be reasonably possible that the reinsurer [company] assuming the contracts may realize a significant loss from the transaction." See NAIC, Accounting Practices and Procedures Manual 22-3, presently, reflected as paragraph 12 of the Statement of Statutory Accounting Procedures (SSAP) No. 62 in the NAIC's Accounting Practices and Procedures Manual (March 2001). (The state insurance regulators were concerned that financing transactions were being disguised as reinsurance.) Indemnification of the ceding company against loss or liability relating to insurance risk in reinsurance requires both of the following : (1) The reinsurer assumes significant risk under the reinsured

underwriting loss are accounted for as a deposit by the assuming insurance company. It may be appropriate to treat the purchaser of such an arrangement as not having insurance as well.

Issue 2

Section 461(a) of the Internal Revenue Code provides, in part, that the amount of any deduction shall be taken for the taxable year which is the proper taxable year under the method of accounting used in computing taxable income.

Section 1.461-1(a)(2)(i) of the Income Tax Regulations provides, in part, that under the accrual method of accounting, a liability (as defined in § 1.446-1(c)(1)(ii)(B)) 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.

Section 1.461-4(a)(1) provides, in part, that for purposes of determining whether an accrual basis taxpayer can treat the amount of any liability as incurred, the all events test is not treated as met any earlier than the taxable year in which economic performance occurs with respect to the liability.

Section 461(h)(2)(C) provides, in part, that if the liability of the taxpayer requires a payment to another and arises under any workers compensation act or out of any tort, economic performance occurs as the payments to such person are made. See also § 1.461-4(g)(2).

Section 1.461-4(g)(1)(i) provides that economic performance does not occur as a taxpayer makes payments in connection with such a liability to any other person, including a trust, escrow account, court-administered fund, or any similar arrangement, unless the payments constitute payment to the person to which the liability is owed under § 1.461(g)(1)(ii)(B). Instead, economic performance occurs as payments are made from that other person or fund to the person to which the liability is owed.

Section 1.461-4(g)(1)(ii)(B) provides that payment to the person to whom the liability is owed is accomplished if a cash basis taxpayer in the position of that person would be treated as having actually or constructively received the amount of the payment as gross income under the principals of § 451, without regard to any provision which specifically excludes the amount from gross income. Thus, for example, the purchase of an annuity contract or any other asset generally does not constitute

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portions of the underlying insurance contracts. (2) It is reasonably possible that the reinsurer may realize a significant loss from the transaction. (Underlining supplied.)

payment to the person to which the liability is owed unless the ownership of the contract or other asset is transferred to that person.

Section 1.461-4(g)(8) Example 1, describes the application of the economic performance requirement to a liability arising out of a tort. In the example Z corporation, an accrual method taxpayer, agrees to purchase an annuity contract that will pay A, the claimant, $50,000 annually for a period of 25 years. In the same year Z pays an unrelated insurance company $491,129 for such an annuity contract. Z retains ownership of the contract. Economic performance occurs with respect to Z's liability as each payment is made to A. Thus, $50,000 is incurred by Z for each taxable year that a payment is made to A. The result is the same if Z secures the obligation with a standby letter of credit.

Assuming that the arrangement between Taxpayer and IC to retroactively reinsure known losses arising under workers compensation acts, does not constitute insurance for federal income tax purposes, the premiums paid are payments to another person under § 1.461-4(g)(1)(i). Since Taxpayer retains ownership of the policy or contract, economic performance occurs as the claimant, the person to whom the liability is owed, receives each payment.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

[redacted] [8] [redacted]

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[8] [redacted]

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[redacted]

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