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

OFFICE OF
CHIEF COUNSEL

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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR

FROM: CAROL P. NACHMAN, Special Counsel CC:DOM:FS:FI&P

SUBJECT:

This Field Service Advice responds to your memorandum dated September 9, 1998. Field Service Advice is not binding on Examination or Appeals and is not a final case determination. This document is not to be cited as precedent.

LEGEND:

Taxpayer =
Fund =
State A =
State A Code =
Year 1 =
Year 2 =
Year 3 =
Date 1 =
Date 2 =

ISSUES:

1. Whether the recurring item exception to economic performance, provided at I.R.C. § 461(h)(3)[1], is applicable to liabilities incurred for the provision of workers' compensation insurance.

2. Whether the arrangement in this case is "insurance" for federal income tax purposes.

CONCLUSION:

1. Although generally taxpayers may not use the recurring item exception with respect to liabilities payable under a workers compensation act, taxpayers may use the recurring item exception with respect to liabilities incurred for the provision of workers' compensation insurance. That the insurance covers workers compensation liabilities does not affect this determination.

2. The arrangement in this case appears to be insurance. As discussed infra, however, additional facts must be developed in this regard.

FACTS:

Taxpayer is a State A corporation taxable under subchapter S of the Internal Revenue Code. Under the laws of State A, an employer must make payments to a workers' compensation "insurance" fund ("Fund") administered by State A. Employers are required to make two semi-annual payments to the Fund on Date 1 and Date 2. The amount of each premium payment is computed with respect to the employer's payroll for the preceding six month period. Premiums are determined with respect to the hazards associated with each employee's job classification and the employer's total payroll attributable to each such job classification. In addition, the employer's specific loss experience is taken into account for the purpose of determining premiums. The Fund's administrator in setting or revising rates must furnish to employers the basis for the established rates. State A Code § . State A also requires the Fund's administrator to make available to employers retrospective rating plans.[2] State A Code § . Moreover,

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[1] Unless otherwise indicated, all section references are to the Internal Revenue Code of 1986, as amended.

[2] Under a retrospectively rated policy, an "insured" party is required to pay additional premiums if actual losses exceed a certain threshold; conversely, the "insured" party receives a refund of premiums paid if actual losses fall below a certain

State A permits certain employers to “self-insure” their risks in lieu of directly participating in the Fund. Self-insured employers, however, are subject to strict requirements. State A Code § .

During taxable Years 1 and 2, Taxpayer made payments to the Fund. Taxpayer was a calendar year taxpayer which reported items of income and expense on an accrual basis; accordingly, Taxpayer claimed deductions with respect to amounts paid to the Fund as those amounts accrued, rather than when they were actually paid. For example, on its return for Year 2, Taxpayer accrued as an expense payments made to the Fund on Dates 1 and 2 of Year 3. Thus, Taxpayer claimed deductions for amounts payable to the Fund for the taxable year prior to the year in which the payments were actually made.

The parties dispute the timing of Taxpayer’s claim for deductions with respect to its liabilities to the Fund. Taxpayer argues that because the payments are for “insurance,” rather than for workers’ compensation liabilities, each payment constitutes a “recurring item,” and is deductible in the year in which it is accrued as long as the payment is actually made within eight and one-half months after the close of the taxable year. See § 461(h)(3)(A) (providing that certain recurring items are deemed incurred during a taxable year if actually paid within 8 ½ months after close of such taxable year). The revenue agent assigned to this case argues that, regardless of whether the payments may be characterized as “insurance,” the payments are workers’ compensation liabilities which cannot be deducted until actually paid. See § 461(h)(3)(C) (providing that workers compensation liabilities cannot be considered recurring items).

LAW AND ANALYSIS

1. Timing of Taxpayer’s claim for deductions relating to payments made to the Fund.

We first turn to the question of whether payments for workers’ compensation insurance may be deducted before they are actually paid. Premiums paid for “insurance” are deductible if directly connected with the taxpayer’s trade or business. Treas. Reg. § 1.162-1(a). Section 461 generally requires that deductions must be taken for the taxable year which is the proper taxable year under the taxpayer’s method of accounting used in computing taxable income. In this regard, under § 461(h)(4) an item of expense is not deductible until “all events have occurred which determine the fact of liability and the amount of such liability

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threshold. In this case, it is unclear whether Taxpayer elected to participate in the Fund on a retroactively-rated basis.

can be determined with reasonable accuracy." Section 461(h)(1) further provides that an item of expense cannot be deducted until economic performance with respect to such item occurs. Section 461(h)(2)(C) provides that if the taxpayer incurs a liability which requires payment to another person, and such liability arises under any workers compensation act, economic performance occurs as the payments to such person are actually made. Treas. Reg. § 1.461-4(g)(2)-(7) also enumerates six classes of liabilities for which economic performance is not deemed to occur until actual payment is made to the person to which the liability is owed. Treas. Reg. § 1.461-4(g)(2) and (5) provide in pertinent part:

> (g) Certain Liabilities for which payment is economic performance.
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> * * * * * * *
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> (2) Liabilities arising under a workers compensation act or out of any tort, breach of contract, or violation of law. If the liability of a taxpayer requires a payment or series of payments to another person and arises under any workers compensation act or out of any tort, breach of contract, or violation of law, economic performance occurs as payment is made to the person to which the liability is owed.
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> * * * * * * *
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> (5) Insurance, warranty, and service contracts. If the liability of a taxpayer arises out of the provision to the taxpayer of insurance, ... economic performance occurs as payment is made to the person to which the liability is owed .... For purposes of this paragraph (g)(5) –
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>> (ii) The term "insurance" has the same meaning as is used when determining the deductibility of amounts paid or incurred for insurance under section 162.

There is an exception to the requirement of economic performance, however, which applies to certain "recurring items" of liability. § 461(h)(3); <u>see also</u> Treas. Reg. § 1.461-5(a). Under the recurring item exception, a taxpayer may deduct certain items of expense if the "all events" test has been met, although economic performance has not yet occurred. Treas. Reg. § 1.461-5(c), however, provides that the recurring item exception is not applicable to liabilities described in Treas. Reg. § 1.461-4(g)(2), i.e, liabilities arising under a workers' compensation act. Accordingly, the recurring item exception is available to a taxpayer incurring a recurring liability for insurance coverage, but not to a taxpayer incurring a liability arising under a workers compensation act.

In this case, the revenue agent relies upon § 461(h)(2)(C), which provides that economic performance for workers' compensation liabilities occurs as payment is actually made, and § 461(h)(3)(C), which provides that the recurring item exception to economic performance cannot apply to workers' compensation liabilities. Thus, the revenue agent argues that Taxpayer's payments to the Fund cannot be deducted until actually paid because they are considered workers' compensation liabilities. On the other hand, Taxpayer contends that the payments to the Fund are for "insurance," rather than for actual workers' compensation liabilities. Accordingly, Taxpayer argues that, pursuant to the recurring item exception to the economic performance requirement, the "insurance" premiums paid to the Fund may be deducted before actually paid.

Although the recurring item exception is not applicable to workers' compensation liabilities, the exception is applicable to liabilities incurred for insurance coverage. Thus, assuming that the transaction in question is insurance, we conclude that Taxpayers are entitled to use the recurring item exception with respect to the premiums paid to the Fund. In this regard, we believe that § 461(h)(3)(C) should not be interpreted so broadly so as to include payments for workers' compensation insurance. In so doing, we recognize that Treas. Reg. § 1.461-4(g)(8), Example 6, which you cited in your request for advice, explains that an expense for workers' compensation insurance cannot be deducted until actually paid. That example, however, assumes that the recurring item exception is not used by the taxpayer.

2. Whether the arrangement in this case is "insurance."

Although the Internal Revenue Code does not define the term "insurance," courts have generally required that a transaction involve both "risk shifting" (from the insured's perspective) and "risk distribution" (from the insurer's perspective) in order to be characterized as insurance. Helvering v. LeGierse, 312 U.S. 531, 539 (1941); Gulf Oil Corp. v. Commissioner, 914 F.2d 396, 411 (3rd Cir. 1990). The risk transferred pursuant to an insurance contract must be a risk of economic loss. Allied Fidelity Corp. v. Commissioner, 66 T.C. 1068 (1976), affd., 572 F.2d 1190 (7th Cir. 1978). Consistent with the principle enunciated in LeGierse, Taxpayer's participation in the Fund will be treated as insurance, provided that the requirements of risk shifting and risk distribution are present.

In this case, State A established the Fund as a means of assuming the workers' compensation risks of employers in State A. Taxpayer pays an arm's length, actuarially determined amount to the Fund in exchange for the Fund's assumption of Taxpayer's risks. The premiums paid by Taxpayer depend on the amount of its payroll, the nature of work provided by its employees, and its past loss experience. Therefore, Taxpayer's liability for its workers' compensation risks for any year appears to be limited to the premium paid to the fund. In this regard, the laws of State A make a clear distinction between employers participating in the Fund, and qualified employers who elect to retain their own risks by "self-insuring." Accordingly, it appears that the arrangement in this case involves sufficient risk transfer to constitute insurance for tax purposes. As discussed infra, however, additional facts must be developed to determine with certainty whether risk was actually shifted.[3]

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS:

We suggest that you develop additional facts to confirm whether risk shifting and risk distribution are present. If closer scrutiny of the arrangement reveals that Taxpayer has, in effect, retained liability for its workers' compensation risks, then the payments to the Fund will not be for insurance. In this regard, it is unclear whether Taxpayer premiums paid to the Fund were determined on a retrospectively rated basis. Under such an arrangement, an "insured" party is required to pay additional premiums if actual losses exceed a certain threshold; conversely, the "insured" party receives a refund of premiums paid if actual losses fall below a certain threshold. If Taxpayer elected to do so, it is necessary to examine the terms of such an arrangement to determine whether risk was shifted. In this regard, risk is not sufficiently shifted if the retrospective premium adjustment effectively requires Taxpayer to reimburse the Fund for nearly all payments made by the Fund on Taxpayer's behalf. In addition, risk would not be shifted if Taxpayer is entitled to a refund of all premiums paid to the extent that the premiums exceed actual losses.

In addition, it is necessary in this case to determine whether a significant number of employers unrelated to Taxpayer participated in the fund.[4] When the

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[3] Your request for advice concerns only the tax treatment by Taxpayer of the payments it made to the Fund. Accordingly, we express no opinion concerning the Fund's status as an insurance company for federal income tax purposes, nor do we express an opinion concerning the manner in which the Fund should report the amounts paid by Taxpayer.

[4] This concern is illustrated in Rev. Rul. 83-172, 1983-2 C.B. 107, where the Service addressed the tax status of a fund created by a group of 40 unrelated employers which established the fund for the purpose of covering each member's workers' compensation risks. No single participant provided greater than 5% of the risks assumed by the fund. At issue was whether the arrangement involved sufficient risk shifting and risk distribution to warrant recognition of the fund as an insurance company for tax purposes. The Service concluded that the arrangement was insurance for federal income tax purposes.

number of participants in an insurance fund diminishes, the risk retained by each "insured" increases. If you do not have any information available, we suggest that you contact the administrator of the Fund for the purposes of determining the percentage of Taxpayer's risks held by the Fund relative to all of the risks held by the Fund.