OFFICE OF
CHIEF COUNSEL

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR DISTRICT COUNSEL, SOUTHERN CALIFORNIA
CC: WR: SCA
Attn: June Y. Bass, Assistant District Counsel.
Paul B. Burns, Special Litigation Assistant

FROM: Deborah Butler
Assistant Chief Counsel (Field Service) CC:DOM:FS

SUBJECT:

This Field Service Advice responds to your memorandum, dated November 3, 1998, and reconsiders and supplements Field Service Advice, dated April 16, 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:

Corp X	=	
Corp Y	=	
Corp Z	=	
Corp A	=	
Country B	=	
Products C	=	
Date d	=	
Date e	=	
$f	=	$
$g	=	$
$h	=	$
$j	=	$
Year k	=	

Year m =
Year n =
Year p =

ISSUE:

Whether "premium payments" made by Corp X under the second arrangement described below are "deposits" and, as a result, not income to Corp Z.

CONCLUSION:

"Premium payments" made by Corp X under the second arrangement are not "deposits" and are income to Corp Z.

FACTS:

The following summarizes facts and conclusions that are more fully stated in our original Field Service Advice to you.

Corp X is a foreign corporation incorporated in Country B. It and its related companies design, manufacture and distribute Products C. Corp X owns all the outstanding stock of Corp Y, which under license from Corp X, engineers and manufactures products. Corp X also owns all the outstanding stock of Corp Z, which purchases products from Corp X and Corp Y and resells them to dealers throughout the United States.

Under state product liability laws, Corp X, Corp Y and Corp Z are jointly and severally liable for product liability claims. On Date d the three corporations executed a Product Liability Agreement under which Corp X agreed to indemnify Corp Y and Corp Z for liability expenses under product liability claims, including payments for settlements, judgments, insurance premiums and costs incurred in defending claims. For the earlier tax years, Corp Z issued monthly invoices to Corp X for the liability expenses and Corp X paid them.

These reimbursements were addressed in issues 1 and 2 of our original Field Service Advice. We concluded that the reimbursements could potentially be income to Corp Z with a corresponding deduction for the liability expenses incurred. However, we thought the preferable treatment for Corp Z would be for no income to result from the reimbursements, and for no deduction to be allowed for the liability expenses; that is, income and expenses should be netted.

In subsequent years, Corp X, Corp Y and Corp Z began to handle the reimbursements of the liability expenses in a different manner. This second arrangement was addressed in issue 3 of the original Field Service Advice and is

the subject of your request for reconsideration. On Date e, Corp Z incorporated Corp A as a wholly owned subsidiary. In the same year, Corp A issued a one year insurance policy jointly to Corp X, Corp Y and Corp Z, to cover claims which resulted in damages between $f to $g. Corp X made annual "premium payments" to Corp A, and each year, Corp A "loaned" all available cash to Corp Z. Then, at the end of each year, Corp Z repaid the "loans" with interest, and took out a new "loan" for the next year. These policies were renewed annually and the second arrangement was continued until the end of Year k.

According to the taxpayer's submission, the "premiums" paid by Corp X far exceeded the liability expenses paid out by Corp A. As a result, Corp A paid "dividends" to Corp Z of $h in Year m and of $g in Year p. Corp Z used the Year m "dividend" and other funds to pay a dividend of $j to Corp X in Year n.

Our understanding of the second arrangement was that it functioned like the first except that claims between $f to $g were paid from Corp A's account rather than using the Corp X reimbursement process. As such, in our original Field Service Advice, we found the payments made under the second arrangement to be in substance like those made under the first. The purported premium payments were recharacterized as taxable advance reimbursement payments by Corp X to Corp Z for future product liability claims made by customers against Corp Z. After receiving these payments, Corp Z should have been treated as making constructive capital contributions to Corp A, (arguably a captive insurance company) in order to fund any future product liability claims that might arise.

Our ultimate conclusion in regard to both the first and second arrangements was that the payments by Corp X were not capital contributions to Corp Z, as had been asserted by Corp Z. Instead, they represented reimbursement payments for product liability expenses under the first arrangement, and advance payments for future potential liabilities under the second. Thus, under both arrangements, the parties never intended these payments to be nontaxable shareholder capital contributions under I.R.C. § 118.

However, there remained an unresolved distinction between our suggested treatments of the first and second arrangements. That is, we had found the preferable treatment for the first arrangement was that there be no taxable income and no deduction for Corp Z and, for the second, that there was income to Corp Z. You have raised the possibility that the payments under the second arrangement should be considered "deposits" and therefore not taxable income to Corp Z.

LAW AND ANALYSIS:

The issue of whether a payment is income or a deposit has received much consideration in recent years because of the Supreme Court's decision in

Commissioner v. Indianapolis Power & Light Co., 493 U.S. 203 (1990). In Indianapolis Power, a utility that generated and sold electricity, required certain customers with suspect credit to make deposits to insure prompt payment of future utility bills. The customer was entitled to a refund of his or her deposit after either making timely payments for a certain period of months or satisfying a credit test. The customer could then choose to take his or her refund by cash or check or to apply the refund against future bills. The deposits were commingled with other receipts and at all times were subject to the taxpayer's unfettered use and control.

The Commissioner argued the amounts were advance payments immediately includable in income; while the taxpayer argued they were analogous to loans and as such not taxable. The Court reasoned that the distinction between advance payments and loans was one of degree rather than kind. 493 U.S. at 208. While both bestow some economic benefits to the recipient, economic benefits qualify as income only if they are "undeniable accessions to wealth, clearly realized, and over which the taxpayers have complete dominion." Id. at 209, quoting Commissioner v. Glenshaw Glass Co., 348 U.S. 426, 431 (1955). The key to determining whether a taxpayer enjoys "complete dominion" over a given sum is whether the taxpayer "has some guarantee that he will be allowed to keep the money." Indianapolis Power, 493 U.S. at 210. The proper focus is on the rights and obligations of the parties at the time the payment was made. Id. at 209.

In the case of a loan, the recipient has no guarantee it will be able to keep the money because the funds are acquired subject to an express obligation to repay that does not require the payor to purchase goods or services. If the payor fulfills its legal obligations then the deposit will be refunded to it. Id. at 209. In the case of an advance payment, on the other hand, the recipient is assured that, if it fulfills its contractual obligations, the payor retains no right to insist upon the return of the money and the recipient can keep it. Id. at 210-11. Thus, it is important to determine whether the payor or the recipient controls the conditions under which repayment will be made. See Id. at 212. Because the customers in Indianapolis Power, controlled the ultimate disposition of the deposit and had not committed to purchasing any electricity when the deposit was made, the amount was not income to the taxpayer.

The implications of Indianapolis Power have subsequently been considered in a number of cases. See Alexander Shokai, Inc. v. Commissioner, 34 F.3d 1480 (9th Cir. 1994), cert. denied, 514 U.S. 1062 (1995); Houston Industries, Inc. v. United States, 32 Fed. Cl. 202 (1994), aff'd, 125 F.3d 1442 (Fed. Cir. 1997); Johnson v. Commissioner, 108 T.C. 448 (1997); Herbel v. Commissioner, 106 T.C. 392 (1996), aff'd, 129 F.3d 788 (5th Cir. 1997); Highland Farms, Inc. Commissioner, 106 T.C. 237 (1996); Oak Industries, Inc. v. Commissioner, 96 T.C. 559 (1991); Milenbach v. Commissioner, 106 T.C. 184 (1996); Kansas City Southern Industries, Inc. v. Commissioner, 98 T.C. 242 (1992), acq. in part and nonacq. in part including this

issue, 1994-1 C.B. 1; Michaelis Nursery v. Commissioner; T.C. Memo. 1995-143; Buchner v. Commissioner, T.C. Memo. 1990-417.

The Commissioner has won some of these cases and lost others. However, the present case is distinguishable from all the cases cited in that there is no known requirement here that the "premiums" be returned to the payor, Corp X, under any circumstances. For a loan, or specifically a deposit, to be excluded from income there must be a consensual recognition of an express or implied obligation to repay the amount. See Indianapolis Power, 493 U.S. at 209, quoting James v. United States, 366 U.S. 213, 219 (1961).

The need for an obligation to repay under Indianapolis Power was directly raised in both Milenbach and Michaelis Nursery. In Milenbach, the Los Angeles Raiders football team received $6.7 million dollars in a transaction that was characterized as a loan to be repaid from revenue received from luxury suites the Raiders had yet to build at their stadium. The Commissioner argued that the amount was income and not a loan because there was no unconditional obligation to repay. The court agreed, distinguishing Indianapolis Power because "[t]he Raiders, unlike the power company, were not subject to an express obligation to repay within the lender's control." 106 T.C. at 196.

Similarly, in Michaelis Nursery, amounts paid for trees to be delivered in a subsequent year were found to be advance payments, even though the taxpayer routinely refunded them upon request. The written agreement under which the payments were made required them to be refunded only in limited circumstances where the taxpayer was unable to perform. Because there was no express obligation to repay unless the taxpayer defaulted on his ability to deliver the trees, the taxpayer enjoyed complete dominion over the amounts and they were income when paid.

In the present case, not only is there no express obligation to repay the "premiums," but they may be kept by the recipient so long as it performs under the "insurance" contract. Therefore, the "premiums" are clearly income under the rationale of Indianapolis Power.

That the "premiums" are to be used to pay liability expenses of Corp X also does not change this result. It is true that "[w]here a taxpayer is obligated to dispose of the money it receives in a certain way, accruing no benefit to itself, the funds are considered to be excluded from the taxpayer's gross income." Houston Industries, 32 Fed. Cl. at 210. See Central Life Assurance Society v. Commissioner, 51 F.2d 939, 941 (8th Cir. 1931). However, here Corp Z clearly benefitted from the payment of the liability expenses, because it was also jointly and severally liable on the product liability claims.

Admittedly, there are recent cases involving obligatory payments made for the purpose of reimbursing the recipient for an expense, where the payments were held not to be taxable deposits. See Kansas City Southern (deposit made to reimburse railroad for building "side tracks" from payor's manufacturing facility to the main rail line); Buchner (deposit made to reimburse mailing service for postage). However, in both Kansas City Southern and Buchner, the deposit would have to be paid back to the payor in certain circumstances that were controlled by the payor. Again, the obligatory repayment is the essential distinction from the present case. Thus, cases following Indianapolis Power have found that deposits are income at the point when they become nonrefundable. Highland Farms, 106 T.C. at 252. See Johnson, 108 T.C. at 469.

That Corp Z paid dividends to Corp X that were arguably derived from the overpayment of "premiums" also does not reduce the amount of income reportable. Again, there was no obligation to repay the "premiums." In addition, Corp X and Corp Z are arguably bound by their characterization of these amounts as dividends rather than repayments. See the discussion in issue 2 of our original Field Service Advice regarding the possibility of binding the taxpayer under the rule of Commissioner v. Danielson, 378 F.2d 771 (3d Cir. 1967), cert. denied, 389 U.S. 858 (1967) and related rules arguably applicable to the Ninth Circuit. See also Taiyo Hawaii Co., Ltd. v. Commissioner, 108 T.C. 590 (1997); City of New York v. Commissioner, 103 T.C. 481 (1994), aff'd, 70 F.3d 142 (D.C. Cir. 1995); Litchfield v. Commissioner, T.C. Memo. 1994-585, aff'd in an unpublished order, 97-2 USTC ¶50,536 (10th Cir. 1997); Miller v. Commissioner, T.C. Memo. 1989-153, aff'd in an unpublished opinion, (6th Cir. 1990), where taxpayers were bound by their characterizations of amounts as either debt or equity.

But more basically, Indianapolis Power does not change the rule that income is reportable even though it may have to be returned some time in the future. Johnson, 108 T.C. at 470-71; Herbel, 106 T.C. at 417. See also Alexander Shokai, 34 F.3d at 1485-86, which is controlling in the present case. In interpreting the implications of Indianapolis Power in Johnson, the Tax Court noted the "large body of case law" supporting the contention that "[n]ot all refundable payments can be excluded from income." Johnson, 108 T.C. at 470. Significantly, among the cases Johnson cited for this proposition is Brown v. Helvering, 291 U.S. 193 (1934), where insurance commissions were found to be income even though they were repayable in the event the policy was canceled. Thus, advance payments are income when they are payments for services to be supplied, as they were asserted to be in the present case. See Indianapolis Power, 493 U.S. at 207.

Your request for reconsideration has raised what could be considered a logical inconsistency in the original Field Service Advice; specifically, our assertion that the premium payments under the second arrangement should be reported in income appears at odds with our finding that the preferable treatment for the

reimbursements paid under the first arrangement would not be reported in income. That is, the reimbursements would be netted against the liability expenses paid out by Corp Z so that neither income nor expense would be reported by Corp Z. This apparent inconsistency is underscored by our having recharacterized the second arrangement because it was in substance like the first. However, the second arrangement is distinguishable from the first in that the liability expenses had not yet been incurred when the premium payments were made. This distinction is the basis for our differing conclusions regarding whether the payments should be income.

As discussed in our original Field Service Advice, one reason taxpayers are not allowed a deduction for expenses for which they have a right or expectation of reimbursement is that such expenditures are considered in the nature of nondeductible loans. Burnett v. Commissioner, 356 F.2d 755, 759 (2d Cir. 1966), cert. denied, 385 U.S. 832 (1966); Flower v. Commissioner, 61 T.C. 140, 152 (1973), aff'd without opinion, 505 F.2d 1302 (5th Cir. 1974). Correspondingly, reimbursements have been held not to be income in circumstances where the corresponding expenses have not been deducted. See Estate of Adame v. Commissioner, 37 T.C. 807, 814 (1962), aff'd in part and rev'd in part on other issues, 320 F.2d 811 (5th Cir. 1963), acq. on other issues, 1963-2 C.B. 3; Cochrane v. Commissioner, 23 B.T.A. 202, 208 (1931), acq. X-2 C.B. 14 (1931); Rev. Rul. 80-348, 1980-2 C.B. 31; Rev. Rul. 79-263, 1979-2 C.B. 82. Thus, under this and the other stated rationale, we concluded that income and deduction should be netted if the liability expenses had already been incurred when the reimbursements were paid.

However, if the liability expenses have not yet been incurred when the “premiums” are paid, Corp Z falls under broader precedent holding that reimbursement of a taxpayer's expenses under an agreement is income to the taxpayer. See Old Colony Trust Co. v. Commissioner, 279 U.S. 716 (1929); Silverman v. Commissioner, 253 F.2d 849 (8th Cir. 1958); Taylor v. Commissioner, T.C. Memo. 1981-8. See also Commissioner v. Kowalski, 434 U.S. 77 (1977).

We stand by the conclusions reached in our original Field Service Advice as clarified by the discussion presented here.

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DEBORAH A. BUTLER