Internal Revenue Service

Index No.: 118.00-00
Number: **199951024**
Release Date: 12/23/1999

Department of the Treasury

P.O. Box 7604
Ben Franklin Station
Washington, DC 20044

Person to Contact:

Telephone Number:

Refer Reply To:
CC:DOM:P&SI:5 - PLR-106667-99
Date: 9-27-1999

LEGEND:

Taxpayer =

Corp =

State =

City =

Association =

b =

c =

d =

f =

g =

h =

k =

m =

n =

p =

r =

s =

t =

u =

v =

Dear

This letter responds to Taxpayer's letter dated m, and subsequent correspondence, requesting a private letter ruling that payments received by Taxpayer pursuant to certain agreements are nonshareholder contributions to the capital of Taxpayer under § 118 of the Internal Revenue Code.

The relevant facts as represented in Taxpayer's submission are set forth below.

Taxpayer, a stock property and casualty (P&C) insurance company chartered under the laws of State, is engaged in the business of issuing and underwriting P&C insurance. Taxpayer, a wholly-owned subsidiary of Corp, was organized and commenced business in State in n. The corporate offices of Taxpayer and Corp are located in City. Taxpayer is included in Corp's consolidated federal income tax return.

In the decade preceding Taxpayer's incorporation and commencement of business, the State residential P&C insurance market had deteriorated. Frequent severe storms had resulted in significant losses to P&C insurers doing business in State and had driven several insurers into insolvency and liquidation. Many of the surviving insurers, seeking to minimize their hurricane risk exposure, attempted to stop writing coverage on properties in high-risk areas of State or sought to exclude wind damage from the coverage offered. Other insurers withdrew from the State market or curtailed writing new policies and did not renew existing policies at expiration. These developments left many State homeowners with no viable source of residential P&C insurance coverage.

In b, the State legislature authorized the establishment of the Association to function as a residual market insurer, providing residential P&C insurance to qualified applicants unable to procure such coverage from private insurers. To ensure the solvency of the Association, the State legislature authorized the Association to recoup annual net operating losses through deficit assessments against private insurers writing residential P&C coverage in State. Such assessments are allocated among the private insurers based on the proportion of State residential P&C insurance premium directly written by each. The Association’s premium rates were structured to be higher than most private insurers’ approved rates for comparable coverage so as to be noncompetitive. Despite the adoption of noncompetitive rates, the general unavailability of residential P&C coverage within State led to a rapid increase in the number of policies issued by the Association and resulted in the Association becoming the primary residential P&C insurer in many areas of the state.

In p, the State legislature declared that the Association had written an amount of policies beyond legislative expectations and that the Association had become, by virtue of its size, a significant impediment to the restoration and competitive residential property insurance market in State. It also declared that the public policy of State required the maintenance of a residual market for residential property insurance, and that extraordinary measures were required to reduce the number of policies written by the Association to a reasonable level.

It was the intent of the legislature to provide financial incentives to encourage the replacement of the highest possible number of Association policies with policies written by admitted insurers at approved rates. Thus, the State legislature enacted legislation requiring the Association to pay a "take-out bonus" of up to $d to an insurer for each risk that the insurer removes from the Association, either by issuance of a policy upon expiration or cancellation of the Association policy or by assumption of the Association’s obligations with respect to an in-force policy. Such payment is subject to the approval of the Association Board. In order to qualify for the take-out bonus, the take-out plan must include a minimum of c policies.

Further, the insurer must renew the replacement policy at approved rates on substantially similar terms for r additional s-year terms, unless canceled by the insurer for a lawful reason other than hurricane exposure. If an insurer assumes the Association’s obligations for a policy, it must issue a replacement policy for an s-year term upon expiration of the Association policy and must renew the replacement policy at approved rates on substantially similar terms for r additional s-year terms, unless canceled by the insurer for a lawful reason other than hurricane exposure. For each replacement policy canceled or nonrenewed by the insurer for any reason during the f-year coverage period, the insurer must remove from the

Association one additional policy covering a risk similar to the risk covered by the canceled or nonrenewed policy. In addition, the Association must place the bonus monies in escrow for a period of f years, and the monies may be released from escrow only to pay claims.

Taxpayer commenced its State business late in n, by removing policies from the Association pursuant to agreements executed on g. The Policy Takeout Agreement ("Agreement") is the relevant agreement in the present case. The Agreement sets forth the terms and conditions under which Taxpayer is entitled to the takeout bonuses. The key provisions of the agreement are as follows. First, the Agreement requires Taxpayer to remain licensed and authorized to transact P&C insurance business in State during the term of the Agreement or for so long as the escrow account established in accordance with the Agreement exists. Second, all monies in the escrow account will be returned to the Association if Taxpayer fails to remove at least c policies from the Association within t calendar months of the commencement of the Agreement. Third, should Taxpayer fail to maintain at least c removed policies for a period of u days, such failure will be deemed a default by Taxpayer. Last, the Taxpayer must renew the policies issued in substitution for the Association's policies at Taxpayer's approved rates and on substantially similar terms for r additional v month policy periods after the initial v month policy period unless canceled or nonrenewed by Taxpayer for reasons permitted by applicable law. Upon such cancellation or nonrenewal of a policy, Taxpayer must remove a similar policy from the Association for each policy canceled or nonrenewed, within u days, or as reasonably close to u days as possible, of the cancellation or nonrenewal.

The maximum per policy takeout bonus was set by the State legislature at $d. The originally calculated per policy takeout bonus was $k. Taxpayer removed approximately h policies. However, the final takeout bonus amount will be calculated at the end of the takeout period because the calculation depends on the number of removed policies maintained by Taxpayer at the end of the f-year takeout period.

Taxpayer requests rulings that 1) amounts to be received by Taxpayer pursuant to the Takeout Bonus program will be treated under § 118(a) as contributions to Taxpayer's capital, and 2) for purposes of application of the basis adjustment rules of § 362(c), amounts to be received by Taxpayer under the Takeout Bonus program will be treated as contributions received on the dates that Taxpayer actually receives distributions of cash from the escrow account.

Section 118(a) provides that in the case of a corporation, gross income does not include any contribution to the capital of the taxpayer.

Section 1.118-1 of the Income Tax Regulations provides that the exclusion under § 118 applies to contributions to capital made by persons other than shareholders. For example, the exclusion applies to the value of land or other property contributed to a corporation by a governmental unit or by a civic group for the purpose of inducing the corporation to locate its business in a particular community or to enable the corporation to expand its operating facilities. However, the exclusion does not apply to any money or property transferred to the corporation in consideration for goods or services rendered, or to subsidies paid to induce the taxpayer to limit production.

The legislative history to § 118 indicates that the exclusion from gross income for nonshareholder contributions to the capital of a corporation was intended to apply to those contributions that are neither gifts, because the contributor expects to derive indirect benefits, nor payments for future services, because the anticipated future benefits are too intangible. The legislative history also indicates that the provision was intended to codify the law that had developed through administration and court decisions. H.R. Rep. No. 1337, 83d Cong., 2d Sess. 17 (1954); S. Rep. No. 1622, 83d Cong., 2d Sess. 18-19 (1954).

In United States v. Chicago, Burlington & Quincy Railroad Co., 412, U.S. 401, 413 (1973), the court articulated five characteristics of a nonshareholder contribution to capital. First, the payment must become a permanent part of the transferee's working capital structure. Second, it may not be compensation, such as a direct payment for a specific, quantifiable service provided for the transferor by the transferee. Third, it must be bargained for. Fourth, the asset transferred foreseeably must benefit the transferee in an amount commensurate with its value. Last, the asset ordinarily, if not always, will be employed in or contribute to the production of additional income and its value assured in that respect.

In Brown Shoe Co. v. Commissioner, 339 U.S. 583 (1950), 1950-1 C.B. 38, the Supreme Court held that money and property contributions by community groups to induce a shoe company to locate or expand its factory operations in the contributing communities were nonshareholder contributions to capital. The Court reasoned that when the motivation of the contributoirs is to benefit the community at large and the contributors do not anticipate any direct benefit from their contributions, the contributions are nonshareholder contributions to capital.

A critical factor in any determination whether a payment qualifies as a nonshareholder contribution to the capital of a corporation is the motivation of the transferor. If the transferor receives a direct benefit as a result of the contribution, the payment is not a contribution to capital. In the instant case, the Association established by the State to be a residual P&C issuer instead became the primary residual P&C insurer in many areas of the State. The Association had written an amount of policies beyond what had been anticipated by the State. The excess policies issued by the Association commensurately increased the Association's liability exposure. The payments provided under the plan were a necessary incentive, in light of the State's hurricane risk exposure, to induce private insurers participation in the removal of policies from the Association.

In the instant case, payments made to Taxpayer pursuant to the take-out bonus plan whereby policies were removed from the Association directly benefit the Association by reducing the Association's liability exposure. Therefore, payments received by Taxpayer pursuant to the take-out bonus plan are not contributions to capital under § 118(a). Further, because the basis adjustment rules under § 362(c) apply only in the case of contributions to capital, Taxpayer's ruling request 2 is rendered moot.

Except as specifically set forth above, no opinion is expressed concerning the federal income tax consequences of the above described facts under any other provision of the Code or regulations. This ruling is directed only to the taxpayer who requested it. Section 6110(k)(3) provides that it may not be used or cited as precedent.

Sincerely yours,

Walter Woo

Walter H. Woo
Senior Technician Reviewer
Branch 5
Office of the Assistant
Chief Counsel

(Passthroughs and Special
Industries)

Enclosures:
Copy for 6110(k)(3) purposes
Copy for filing purposes