Office of Chief Counsel
Internal Revenue Service
memorandum

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date: August 14, 2014

to: CATHY A. GOODSON
(Associate Area Counsel, Area 5)

from: SARAH LASHLEY
Assistant to the Branch Chief
(CC:FIP:B04)

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subject:

This Chief Counsel Advice responds to your request for assistance. This advice may not be used or cited as precedent.

LEGEND

TAXPAYER =

PARTNERSHIP =
PARENT LLC =
SUBORDINATE LLCs =

STATE =

ISSUES

Whether TAXPAYER has income and deductions with respect to a “deductible reimbursement policy” it issued to PARENT LLC.

Whether TAXPAYER will need to recapture its loss reserve balance into income under § 481.

CONCLUSION

Whether TAXPAYER is entitled to income and deductions with respect to the "deductible reimbursement policy" depends on the characteristics of the arrangement.

Regardless of whether TAXPAYER is entitled to income and deductions or not, it is likely that moving from TAXPAYER's current method to the appropriate method of accounting would be a change in method supporting an adjustment, including the loss reserve balance, under § 481.

FACTS

Through direct and indirect ownership of disregarded entities, PARTNERSHIP owns PARENT LLC. PARENT LLC owns, directly and indirectly, several subordinate LLCs ("SUBORDINATE LLCs"). All the LLCs are single member LLCs disregarded for federal income tax purposes.

PARENT LLC, provides personnel services to its client companies through SUBORDINATE LLCs. Because they provide personnel services for the client companies PARENT LLC and SUBORDINATE LLCs are the "employers of record" under state law for the client companies' employees. As one of the personnel services provided to the client companies, SUBORDINATE LLC s provide worker's compensation insurance to the client companies for which it charges the client companies an additional fee or surcharge. As the employer of record, PARENT LLC and SUBORDINATE LLCs are also jointly and severably liable to obtain worker's compensation insurance for the client companies' employees.

PARENT LLC obtains worker's compensation coverage for the SUBORDINATE LLCs from a third party insurer. Under the terms of that policy, at the end of a fifty-four month period, the insurer calculated a final premium equal to the total amount it paid to cover the deductible. PARENT LLC was liable for the excess of the final premium over its initial premium deposit ("premium deficiency").

PARENT LLC owns 100% of TAXPAYER, a STATE non-life insurance company that files an 1120PC. PARENT LLC purchased a "deductible reimbursement policy" from TAXPAYER that covered the premium deficiency and protected the SUBORDINATE LLCs against the risk of loss for payments it may owe to the third party insurer.

PARENT LLC's policy is TAXPAYER's only business.

PARTNERSHIP deducted the amount PARENT LLC paid TAXPAYER for the deductible reimbursement policy. The Service proposes to disallow PARTNERSHIP's deduction.

LAW AND ANALYSIS

In a CCA issued to SB:SE on September 20, 2013, the National Office advised that TAXPAYER was not an insurance company for federal income tax purposes.

Section 446 and the related regulation provide the general rules for methods of accounting. The term “method of accounting” includes not only the overall method of accounting of the taxpayer but also the accounting treatment of any material item. A material item involves the proper time for the inclusion of the item in income or the taking of a deduction. (Treas. Reg. §§ 1.446-1(a) and 1.446-1(e)(2)(ii)(a)). A change in method of accounting does not include adjustments of any item that does not involve the proper time for the inclusion of the item of income or the taking of a deduction. (Treas. Reg. § 1.446-1(e)(2)(ii)(b)). Therefore, a practice that permanently changes the taxpayer's lifetime income, not merely a change in the timing of income, is not a change in method of accounting. (Rev. Proc. 91- 31, 1991-1 C.B. 566, § 3.02.)

Section 481 and the related regulations provide the adjustments rules to prevent amounts from being duplicated or omitted due to the change in accounting method.

In limited circumstances, where an arrangement purporting to be insurance is not insurance for federal income tax purposes, the arrangement may still support a deduction under § 162 as an ordinary and necessary business expense for the parent’s payment of the premium and inclusion of the amount of the premium in the captive’s income under § 61. Any losses paid by the captive, in that case, would be deductible to the captive when paid, and not before because, as stated in Rev. Rul. 2007-47, 2007-30 I.R.B. 127, “[i]f an arrangement is not an insurance contact, no reserves are permitted for unearned premiums or for discounted unpaid losses with respect to the arrangement.”

Whether TAXPAYER is entitled to income and deductions with respect to the arrangement will depend on the characteristics of the arrangement. As described in Rev. Rul. 2005-40, 2005-2 C.B. 4, “[i]n order to determine the nature of an arrangement for federal income tax purposes, it is necessary to consider all the facts and circumstances in a particular case, including not only the terms of the arrangement, but also the entire course of conduct of the parties.”

To support income and deductions to TAXPAYER we would consider, among other things, whether: (1) TAXPAYER is regulated by the state as an insurance company; (2) the particular arrangement qualifies as insurance under the state law; (3) TAXPAYER is adequately capitalized; (4) the premium is set under customary insurance industry rating formulas; (5) the parent has not expressly guaranteed the obligations of the captive; and (6) that the documentation underlying the arrangement supports characterization of the arrangement as providing income and deductions for TAXPAYER.

Whether TAXPAYER is entitled to income and deductions or not, we believe it likely that moving from TAXPAYER's current method to the appropriate method of accounting would be a change in method supporting an adjustment, including the loss reserve balance, under § 481.

This writing may contain privileged information. Any unauthorized disclosure of this writing may undermine our ability to protect the privileged information. If disclosure is determined to be necessary, please contact this office for our views.

Please call Sharon Y. Horn at (202) 617-4426 if you have any further questions.