INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM
October 4, 2000

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CASE MIS No.: TAM-105411-99/CC:ITA:B5

District Director:
ATTN:
IRS Examination Division --

Taxpayer's Name:

Taxpayer's Address:

Taxpayer's Identification No:
Years Involved:
Date of Conference:

LEGEND:

Parent =
Taxpayer =
Association =

State =
Contract =
Bonus =
Hurricane =
Year 1 =
Year 2 =
Year 3 =
Year 4 =
p =
q =
r =
s =
t =
u =
v =
w =
x =

y =
z =

ISSUE(S):

1) Under §118(a) of the Internal Revenue Code, are the bonuses paid to the Taxpayer by the Association non-shareholder contributions to capital?

2) Under §§61 and 451, in what year are take-out bonuses includible in the taxable income of Taxpayer?

CONCLUSION(S):

1) The bonuses paid to the Taxpayer by the Association are not non-shareholder contributions to capital under §118(a).

2) Under §§61 and 451, take-out bonuses are includible in the taxable income of Taxpayer beginning on the date Taxpayer removes t policies from the Association's inventory.

FACTS:

Taxpayer is an insurance company licensed to provide insurance to homeowners in State. Taxpayer uses the accrual method of accounting and computes its income based on a calendar taxable year.

The Association was created by an act of the State legislature in Year 1 to serve as a residual market mechanism for residential property insurance coverage following the catastrophic losses caused by Hurricane. Under its enabling statute, the Association must provide residential property insurance coverage to homeowners who cannot obtain this coverage in the voluntary insurance market.[1] The Association underwrites and issues property insurance policies in its own name and establishes its own premium rates, that are designed so as not to compete with the rates charged for a comparable policy in the voluntary market. All insurance companies authorized to write residential property insurance in State are required to become members of the Association and are subject to deficit assessments in the event that the Association's premiums, surplus, and reinsurance resources are insufficient to cover its claims and expenses. The Association's operations are overseen by a Board of Governors

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[1] Residential property insurance coverage consists of the type of coverage provided by homeowners, mobile home owners, renters, condominium unit owners, and similar policies, as well as the type of coverage provided by condominium master policies, apartment building policies, and similar policies.

consisting of state government appointees, insurance industry officials, and consumer advocates. The Association is subject to the regulatory supervision of the State Department of Insurance, that has the same regulatory powers over the Association's business operations as it does over voluntary market insurers. For example, like voluntary market insurers, the Association is required to file an NAIC annual statement each year with the State Department of Insurance, to pay premium taxes, and to obtain regulatory approval of its policy forms and premium rates. For tax purposes, the Association files its returns on Form 1120-PC as a property insurance company taxable under §831.

The Association began writing insurance policies in Year 2. By Year 3, the Association had grown to the point where it had more than r policies in force, representing a potential windstorm exposure of more than s. Due to the rapid growth of its premium writing and the geographic concentration of the insured risks, the State legislature became concerned about the Association's exposure to a catastrophic loss, and the potential assessment liabilities that would be imposed on voluntary market insurers and their policyholders. Moreover, the size of the Association was seen as an impediment to the recovery of the voluntary market for residential property insurance coverage. Accordingly, in Year 3, the State legislature enacted a special statute to create a depopulation program designed to transfer substantial blocks of Association policies to voluntary market insurers. This program included a variety of financial incentives, including bonuses for each insurance policy removed from the Association by a voluntary market insurer.

Taxpayer was one of the voluntary market insurers that wanted to contract with the Association to remove insurance policies from the Association's policy inventory. Before the Association would enter into a contract with Taxpayer, the following criteria were taken into account:

1) The capacity of the Taxpayer to absorb the policies proposed to be taken out of the Association and the concentration of risks of those policies;

2) Whether the geographic and risk characteristics of policies in the proposed contract serve to reduce the exposure of the Association sufficiently to justify a bonus;

3) Whether coverage for risks to be taken out otherwise exists in the admitted voluntary market; and

4) The degree to which the bonus is promoting new capital being allocated by Taxpayer to State residential property coverage.

The Contract was entered into in Year 3. Under the Contract, Taxpayer agreed to remove certain identified policies of the Association by the expiration date of the policies. The removal is effected by the Association providing a notice of nonrenewal to its insureds. Taxpayer then offers its policy to the insureds within a specified period after the Association's notice of nonrenewal. Taxpayer warrants and represents that its policies have been previously filed with, and approved by, the State Department of Insurance and fully satisfy all of the requirements of applicable law and the Contract.

Under the Contract, Taxpayer agrees to offer insurance coverage for an initial 12 month period. In addition, Taxpayer agrees to offer to renew its policies for two additional twelve (12) month periods. If an insured chooses not to renew the policy, Taxpayer does not forfeit its bonus. Taxpayer may cancel a policy for reasons of fraud or nonpayment, or a lawful reason other than the reduction of hurricane exposure. If Taxpayer cancels or nonrenews a policy due to fraud or nonpayment, or any other reason allowed by law, Taxpayer must remove a similar policy from the Association inventory within 30 days of such nonrenewal or cancellation. If such a removal is not made, Taxpayer forfeits the bonus for that particular policy. Taxpayer may cancel or nonrenew only to the extent of 3% of the total of the removed policies.

Under the Contract, the Association and the Taxpayer agree to enter into an escrow agreement under which bonuses will be deposited in an escrow account. Taxpayer reports, on or before the 10th day of every month, the number of policies that it has removed from the Association's inventory during the preceding calendar month. Within 10 days after the Association's receipt of that report, the Association deposits a sum equal to x (the bonus price per policy) multiplied by the number of policies removed by the Taxpayer. In addition, the agreement authorizes the escrow agent to disburse funds to the Taxpayer for the payment of claims against Taxpayer, upon receipt of a written direction from both the insurer and the Association. The agreement also authorizes the escrow agent to invest the funds in accordance with the written direction of Taxpayer among certain categories of investments specified in the agreement.

The bonus price per policy, x, is calculated from a formula developed by the Association. The formula multiplies $100 by certain coefficients, depending upon the location of the insured and whether or not the policy covers wind damage. The value of the takeout bonuses, as calculated according to the formula, can vary from p to q.

The following rules may apply to adjust the amount of the bonus ultimately received by Taxpayer:

(1) Taxpayer will not receive any bonus for a policy that was not accepted by an insured. However, if an insured accepts Taxpayer's policy, and later cancels the policy or chooses not to renew, Taxpayer does not forfeit the bonus for that particular policy.

(2) If Taxpayer cancels or nonrenews a policy, to reduce its risk of hurricane loss in violation of state law, Taxpayer will forfeit the takeout bonus for that particular policy and any investment income earned on that bonus.

(3) If Taxpayer cancels or nonrenews a policy due to fraud or nonpayment, or any other reason allowed by law, Taxpayer must remove a similar policy from the Association inventory, in accordance with the terms of the Contract. If Taxpayer fails to remove a similar policy, then Taxpayer forfeits the bonus for that particular policy and any investment income earned on that bonus.

At the conclusion of y years from the date Taxpayer first removes policies from Association, the Contract provides for an audit of the escrowed funds to verify Taxpayer's performance under the contract and to recalculate, if necessary, the bonus amount in escrow under the bonus formula. Assuming that Taxpayer is not otherwise in breach or default of the Contract, Taxpayer receives, on a monthly basis, an amount equal to x (or the recalculated bonus amount if applicable) multiplied by the number of removed policies that reached their y-year anniversary date. Taxpayer also receives any investment income earned on the takeout bonuses while they were in escrow.

The Contract provides that Taxpayer will be in breach or default of the agreement, and all bonuses and investment income will be forfeited to the Association, if the Taxpayer fails to remove at least t policies within u calendar months from the Commencement date. In Year 3, Taxpayer removed w policies from the Association (z policies more than the required t).

In Year 4, an amendment to state law provided that the bonuses would remain the property of the Association, subject to the prior security interest of an insurer (i.e. Taxpayer), until the bonuses were released from escrow. After being released from escrow, the bonuses would then be considered an asset of an insurer (i.e. Taxpayer), and credited to its capital and surplus.

LAW AND ANALYSIS – ISSUE 1:

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 contributors 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, which originally was established by the State Legislature to be a residual insurance issuer, instead became a primary insurance insurer in many areas of State.

The Association had written an amount of policies beyond what had been anticipated by the State legislature. The excess policies issued by the Association commensurately increased the Association's liability exposure. As a result, the take-out bonus payments provided under the depopulation program were a necessary incentive, in light of State's hurricane risk exposure, to induce private insurer participation in the removal of policies from the Association.

In the instant case, the Association's payments made to Taxpayer pursuant to the take-out bonus plan removed policies from the Association. The removal of policies directly benefits 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).

LAW AND ANALYSIS – ISSUE 2:

Section 61 provides that gross income means income from whatever source derived.

Section 451 provides that the amount of any item of gross income shall be included in the gross income for the taxable year in which received by the taxpayer, unless, under the method of accounting used in computing taxable income, such amount is to be properly accounted for as of a different period.

Section 1.451-1(a) provides that gains, profits, and income are to be included in gross income for the taxable year in which they are actually or constructively received by the taxpayer unless includible for a different year in accordance with the taxpayer's method of accounting. Under an accrual method of accounting, income is includible in gross income when all the events have occurred which fix the right to receive such income and the amount thereof can be determined with reasonable accuracy ("all events test").

It is the right to receive, and not the actual receipt that determines the inclusion of the amount in gross income. When the right to receive an amount becomes fixed, the right accrues. Spring City Foundry Co. v. Commissioner, 54 S.Ct. 644 (1934). For an accrual method taxpayer, that right accrues in the taxable year when all events have occurred that fix the right to receive income, and the amount of the income can be determined with reasonable accuracy. §1.451-1(a). If income is properly accruable under the foregoing rules, accrual may not be postponed merely because of a possibility that the income may have to be returned or may be subject to diminution or offset. Rev. Rul. 58-474, 1958 I.R.B. 70.

To meet the requirements of the all events test, there can be no substantial contingency to a taxpayer's right of receipt or as to the certainty of the amount to be received. Schneer v. Commissioner, 97 T.C. 643 at 649 (1991). The contingency must be real and substantial, and the mere existence of a contingency is insufficient to prevent fixation of the right to receive income. The proper test is whether that right has matured without substantial contingency. King v. Commissioner, T.C. Memo 1984-343 (partners of an accrual-basis partnership received income when paid into retention fund, not in year released, because likelihood that employer would use retained amounts to pay for medical services was extremely remote). Given a fixed or unconditional right to receive income, accrual is proper so long as there is a reasonable expectancy that the income will be ultimately received. Uncertainty as to collection must be substantial and not simply technical. Flamingo Resort, Inc. v. United States, 664 F.2d 1387 (9th Cir. 1980) (accrual basis casino must include face amount of outstanding markers in income in current taxable year). The fact that a taxpayer cannot presently compel payment of the money is not controlling. Commissioner v. Hansen, 360 U.S. 446 (1959) (retail automobile dealer that sold automobile loans to finance company had to accrue in income the portion of the sale price the company placed in a reserve account to secure performance by the dealer).

In applying the all events test, courts have distinguished between conditions precedent, that must occur before the right to income arises, and conditions subsequent, the occurrence of which will terminate an existing right to income but the presence of which does not preclude accrual of income. Charles Schwab v. Commissioner, 107 T.C. 282 (1996). With respect to conditions precedent, *see* Rev. Rul. 69-314, 1969-1 C.B. 139 (under government contract, 10% of contract price for boats built is held in retainage until completion and acceptance by government); U. S. v. General Dynamics, 481 U.S. 293 (1987) (filing of claim by employees for medical expenses is the act that fixes the taxpayer's liability, not the provision of medical services, because failure to file a claim was not a remote possibility); Iler v. Commissioner, 1978 T.C.M. 336 (taxpayer constructing a state highway was not required to include payments on the contract price retained in escrow until the completion of the project and approval by the state); Bizzack Brothers Construction Corp. v. Commissioner, 1980 T.C.M. 41 (same facts and holding as Iler).

With respect to conditions subsequent, *see* Continental Tie and Lumber Co. v. U.S., 286 U.S. 290 (1932) (act fixing right to income was passage of legislation, even though amount to be paid was not fully determinable, because the taxpayer could have estimated amount based on its book figures); Dally v. Commissioner, 227 F.2d 724 (9th Cir. 1955) (contractor's right to income was in year it delivered houses, not in later year when a properly certified invoice was submitted, even though the contract specifically provided for payment upon the submission of a properly certified invoice); Rev. Rul. 98-39, 1998-33 I.R.B. 4 (accrual method manufacturer's liability to pay a retailer for cooperative advertising services is incurred in year services are performed, even though retailer may not submit required claim form until later year).

If the condition is within the control of the taxpayer, it will not prevent the accrual of income. In determining whether a taxpayer enjoys “complete dominion” over a given sum, the crucial point is not whether his use of the funds is unconstrained during some interim period. The key is whether the taxpayer has some guarantee that he will be allowed to keep the money. The taxpayer that receives an advance payment has no obligation to return the funds; so long as the taxpayer fulfills the terms of the bargain, the money is its to keep. Commissioner v. Indianapolis Power and Light Co., 493 U.S. 203 (1990) (utility company collecting deposits from customers did not incur income upon receipt of deposits because deposits were subject to divestment, due to conditions outside taxpayer’s control).

The fact that money is held in escrow does not prevent the accrual of income. *See* Rev. Rul. 65-141, 1965-1 C.B. 210 (advance payments made by students to corporation running a dormitory that were placed in escrow until school term began were income in year payable). In addition, amounts held in reserve that, when paid out, inure to a taxpayer’s benefit by satisfying an obligation the taxpayer would have to pay are considered income to the taxpayer. *See* Firetag v. Commissioner, 1999 T.C.M. 409 (amounts held in reserve accounts are income to professional bail bondsman because they would inure to his benefit, either by paying an obligation of his or by becoming his salary); *See also* Stendig v. Commissioner, 843 F.2d 163 (4th Cir. 1988); Commissioner v. Hansen, 360 U.S. 446 (1959).

In the present case, Taxpayer’s right to income is not fixed until it removes t policies from the Association’s inventory within a specified period of time. Therefore, under the facts provided, Taxpayer has income beginning on the date in Year 3 when it removes t policies. From that date, take-out bonuses are includible in income as policies are removed from the Association’s inventory.

In addition to the requirement that the right to receive income must be fixed, the amount of income must be determinable with reasonable accuracy. The term “reasonable accuracy” means that the amount need not be precisely ascertainable. Resale Mobile Homes, Inc. v. Commissioner, 91 T.C. 1085 (1988); aff’d 965 F.2d 818 (10th Cir. 1992). Where the act fixing the right to receive income has occurred, and the amount can be reasonably ascertained, any adjustments to the amount are administrative procedures, and do not prevent the accrual of income. *See* Continental Tie and Lumber Co. v. U.S., *supra*; Central Cuba Sugar Co. v. Commissioner, 198 F.2d 214 (2nd Cir. 1952) (where the amount of the obligation and its final payment is so certain, adjustments to commission expenses and the final settlement prices do not prevent the accrual of the liability). Finally, estimates may be used, as long as the estimate is made with the facts and procedures available to the taxpayer at the end of the taxable year. Esco Corp. v. United States, 750 F.2d 1466 (9th Cir. 1985) (taxpayer’s deductions for unpaid workers’ compensation expenses were determined with reasonable accuracy and thus allowable).

In the present case, taxpayer's income was determinable with reasonable accuracy at the end of Year 3 by applying the bonus takeout formula to the number of policies removed in that year.

The final issue is whether the state law amendment in Year 4 affects the taxpayer's accrual of income in Year 3. State law defines the nature of a taxpayer's interest in property, but the state-law consequences of that definition are of no concern to the operation of the federal law. United States vs. National Bank of Commerce, 472 U.S. 713 (1985) (where state law provided that bank must honor any withdrawal request depositor might make on a joint bank account, government was allowed to levy the entire bank account, despite possible claims of co-owners of the account; state law regarding rights of depositor's creditors against his account were of no consequence).

In determining how state-defined property rights should be taxed, legal title to the property in question is not the decisive factor in determining whether the government may tax the income accruing to that property. The C.M. Thibodaux Co., Ltd. v. United States, 723 F.Supp. 367 (East. Dist. La. 1989), aff'd 915 F.2d 992 (5th Cir. 1990) (transfer by the taxpayer of a right to receive lease bonus and delay rental payments, although a transfer of property under Louisiana law, was merely an assignment of income under federal tax law, and the payments remained taxable to the taxpayer). Taxation is based on the economic realities of the particular commercial transaction. Id.

In the present case, the year in which Taxpayer's bonuses are includible in income is determined under federal tax law.

CAVEAT(S)

A copy of this technical advice memorandum is to be given to the taxpayer(s). Section 6110(j)(3) of the Code provides that it may not be used or cited as precedent.