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Memorandum

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to: Team Coordinator, Team 1526 (Ann Arbor)
(Large & Mid-Size Business)

from: Associate Area Counsel (Detroit)
(Large & Mid-Size Business)

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subject:

This field attorney advice memorandum responds to your request for assistance. This advice may not be used or cited as precedent.

ISSUES

1. Whether payment of $ in for various services related to environmental remediation liabilities is deductible under I.R.C. section 162.

2. Whether payment of $ in for various services related to environmental remediation liabilities is a "specified liability loss" subject to the ten year net operating loss carry back of I.R.C. sections 172(b)(1)(C) and 172(f).

CONCLUSIONS

1. Only a portion of the total $ payment is deductible in as an environmental remediation expense under I.R.C. section 162. The environmental remediation services for which pre-paid are deductible only as the liability is incurred under I.R.C. section 461 and the

Treasury Regulations. In addition, a portion of the total amount relates to potentially non-deductible capital expenditures.

2. Only a portion of the total $ payment is a “specified liability loss” in ; the remaining expenses do not qualify for “specified liability loss” treatment in because they are not allowable deductions under the Internal Revenue Code.

<u>FACTS</u>

(“ ”) is a manufacturer headquartered in , . For approximately years, owned acres of land in , , on which it operated a manufacturing plant (the “site”). manufacturing operations at the site, as well as the operations of the site’s former owner, contaminated the site and nearby areas, including the River, with polychlorinated biphenyls (“PCBs”). The site was listed on the U.S. Environmental Protection Agency’s (“EPA”) National Priorities List in under the Comprehensive Environmental Response, Compensation, and Liability Act of 1980 (“CERCLA”). On , the EPA dictated the required remediation actions in a Record of Decision (“ROD”), which listed as a “Potentially Responsible Party” and estimated the clean up would cost approximately $. The United States sued under CERCLA, and the parties signed a Consent Decree on , which sets forth remediation liabilities and responsibilities.

In order to comply with the ROD and Consent Decree, and to minimize its out-of-pocket expenses, purchased an exit strategy that consisted of two components: hiring (“ ”), a remediation contractor, and funding “insurance” to cover the costs of the remediation. On the same day it signed the Consent Decree, executed a Liability Transfer and Assumption Agreement (“Liability Transfer Agreement”), under which agreed to assume all of liabilities under the Consent Decree and ROD. also agreed to indemnify and hold harmless from and against all liabilities under the Consent Decree and ROD, as well as third-party claims for bodily injury and property damage caused by the pollutants. The Liability Transfer Agreement has a term of years. and entered into a separate agreement on , in which took title to the site in exchange for payment to of $. This “Property Transfer and Assignment and Assumption Agreement” specifically references the Liability Transfer Agreement of , but additionally agreed to assume liabilities for fines or penalties related to the site arising after .

The Liability Transfer Agreement required that “purchase” or “fund”[1] “insurance policies” to pay for remediation expenses at the site.

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[1] The Liability Transfer Agreement uses both the terms “purchase” and “fund” when referring to obligations under the Agreement. In the “Recitals,” the Agreement states, “The Parties intend

purchased from (" "), through (" "), a risk management insurance benefits company and insurance broker, two "insurance policies": a pollution cost cap policy (with a term of years) and an environmental site liability policy (with a term of years). The cost cap policy covers the actual expenses of the environmental remediation, and the liability policy covers liabilities arising out of personal injury or property damage. paid $ for these policies, and provided the following break down:

Premium for Remediation Cost Cap Policy:	$
(Includes funding for the Experience Account Balance of $)	
Expenses for Insured Remediation Costs:	$
Premium for Site Liability Policy:	$
Interest on late premium payment:	$
Fee paid to to service program:	$
TOTAL:	$

Both policies are "claims-made" policies, i.e., will pay only for expenses or liabilities for which the insured makes claims during the policy term. Section of the Liability Transfer Agreement states that funding these policies is the only compensation it owes . is the named insured under both policies.[2]

Remediation expenses at the site are paid first from the Experience Account. Funded initially with $, it can earn "investment income," which is added periodically to the Experience Account Balance. The contract defines "investment income" as the income earned, quarterly in arrears, calculated as follows: [Prior Experience Account Balance - any remediation expenses paid during the preceding quarter] x (1.03345)^(DaysQ/DaysA).[3] , as the contractor doing the work, must submit periodic expense claims to , the administrator for the fund, in order to be

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that . . . insurance issued by . . . and <u>funded by</u> shall provide remediation cost insurance coverage . . . subject to certain deductibles payable by ." (Emphasis added.) However, in section , "Performance by ," the Agreement states, " shall <u>purchase</u> the . . . ." (Emphasis added.) Because we conclude that the Liability Transfer Agreement constitutes a pre-paid services contract for tax purposes, whether "purchased" or "funded" the insurance is immaterial. payment for the policies constituted its consideration for the Liability Transfer Agreement.

[2] is a contingent named insured on the Cost Cap Policy and the second named insured on the Liability Policy.

[3] DaysQ = the number of days between the date of valuation and calculation of the Prior Experience Account Balance and the date of the valuation can calculation of the Current Experience Account Balance. DaysA = the number of days in the calendar year between the date the contract was executed and its first and subsequent anniversary dates.

paid. If money remains in the Experience Account at the end of the remediation project, is entitled to that excess.

On its year end (" taxable year") federal income tax return, deducted the entire $ it paid to pursuant to the exit strategy arrangement, claiming that the payment was for "insurance" and therefore deductible. This deduction contributed to a net operating loss of $ for the taxable year. sought a refund on Form 1120X for the taxable year ended under I.R.C. section 172(f), which allows a ten year carry back for losses generated by certain environmental remediation expenses. The Form 1120X claim sought a $ income tax refund, which remains unpaid.

LAW AND ANALYSIS

I. Economic Performance, Deductibility of Environmental Remediation Expenses, and Specified Liability Losses

An accrual method taxpayer may deduct allowable expenses in the year in which all the events have occurred that determine the fact of the liability, the amount of the liability can be determined with reasonable accuracy (the "all-events test"), and economic performance occurs. Treas. Reg. § 1.461-1(a)(2). In certain circumstances, however, the all-events test cannot be treated as met any earlier than when economic performance occurs. For instance, economic performance occurs, in the case where services are provided to the taxpayer by another person, when such person provides the services. I.R.C. § 461(h)(2)(A)(i).

Expenses incurred by a business in removing and disposing of environmental waste generally are deductible expenses under section 162, even if such expenses occur only once in the lifetime of a business. See H.G. Fenton Material Co. v. Commissioner, 74 T.C. 584 (1980). However, not all environmental remediation expenses are immediately deductible. Not only must the taxpayer satisfy the all events and economic performance tests, but also the taxpayer must show the contamination is directly attributable to the taxpayer's trade or business. United Dairy Farmers, Inc. v United States, 267 F.2d 510, 519 (6th Cir. 2001). If the taxpayer acquired real property already contaminated, expenses related to that pre-existing contamination are capital expenditures under I.R.C. section 263. Id. at 518. That is, "when a taxpayer improves property defects that were present when the taxpayer acquired the property, the remediation of those defects are capital in nature" because the taxpayer is improving the land beyond the conditions existing at the time it bought the land. Id. United Dairy Farmers presents a persuasive framework for evaluating when remediation expenses are deductible under section 162: "first, the taxpayer contaminated the property in its ordinary course of business; second, the taxpayer cleaned up the contamination to restore the property to its pre-contamination state; third, the cleanup did not allow the taxpayer to put the property to a new use." Id. at 519. To the extent the taxpayer's expenses do not fall under any of these three criteria, the expenses are not deductible under section 162.

To the extent a taxpayer's allowable deductions under all applicable Code provisions, including section 162, exceed its gross income, the taxpayer has a "net operating loss." I.R.C. § 172(c). Generally, a taxpayer may carry back any net operating loss to the previous two taxable years. I.R.C. § 172(b)(1)(A)(i). Section 172(b)(1)(C), however, allows an extended carry back period of ten years for a "specified liability loss." The purpose of the extended carry back provision is to allow, to the extent possible, the matching of expenses with the period in which the event causing the loss occurred.

A "specified liability loss" is an amount allowable as a deduction that, in relevant part, "is in satisfaction of a liability under a Federal or State law requiring . . . the remediation of environmental contamination." I.R.C. § 172(f)(1)(B)(i)(IV). A liability for environmental remediation is a specified liability loss only if the act or omission giving rise to the liability occurred at least three years before the beginning of the taxable year in which the taxpayer claims the loss, and the taxpayer used the accrual method of accounting during the period of the act or omission. I.R.C. § 172(f)(1)(B)(ii). The amount of a specified liability loss for any taxable year may not exceed the other net operating loss for that taxable year. I.R.C. § 172(f)(2). If an expense for environmental remediation is a capital expense, <u>see</u>, <u>e.g.</u>, <u>United Dairy Farmers</u>, 267 F.3d at 519, it cannot be a specified liability loss, because specified liability losses under section 172(f)(1)(B)(i) are limited by the Code's plain language to expenses allowable as a deduction.

A. <u>Economic Performance occurs for Pre-Paid Services Contract as provides remediation services</u>.

made its $ payment in as a condition of its Liability Transfer Agreement with , under which purchased remediation services. The Agreement states at part , page , that obligations include "[a]ssuming the responsibility for, <u>and performance and completion of</u>, Remediation of the Site in accordance with the ROD." (Emphasis added.) Because these services have extended—and will continue—over the course of many years, and because funding the policies constitutes its consideration for the Agreement, exit strategy constitutes a pre-paid services contract. For this reason, only a small portion of the total $ payment is deductible in . may deduct the remainder of the payment as provides it services, as allowable by the economic performance rules and limited by the rule of <u>United Dairy Farmers</u>.

We look to the Liability Transfer Agreement to determine the proper tax treatment for the $ payment because it is the contract that dictates each party's obligations in exit strategy. It describes the obligations of both and , the liabilities assumes, and the method by which must compensate for assuming those liabilities. The policies, although “funded” or “purchased” by , provide only a framework within which will receive the money that pre-paid for services.

The Liability Transfer Agreement is a pre-paid services contract, and under the economic performance rules, economic performance occurs as services are rendered. The all-events and economic performance rules are not met until has provided services and complied with the requirements of the policies. In Section II of the Cost Cap Policy, requires that , as named insured, submit progress and cost reports to at certain intervals. agrees to pay to amounts submitted for payment according to the rules of Section , part . In relevant part, agrees to pay to or on behalf of the amounts that, in good faith determination, has properly substantiated. Because is not entitled to payment until this time, the all-events test and economic performance have not occurred until this time.

Once the all-events and economic performance tests are met, generally may deduct under section 162 the amount to which is entitled. We caution, however, that not all of these amounts may be deductible under section 162. The Property Transfer and Assignment and Assumption Agreement states that assumes liability for any government fines or penalties, which are an example of non-deductible expenses. I.R.C. § 162(f).

In addition, not all remediation expenses are deductible under section 162. Any expenses related to remediation of contamination existing at the time purchased the site are subject to the rule of United Dairy Farmers, and such expenses are capital expenditures. 267 F.3d at 518-19. may claim a current deduction only for the contamination caused by its manufacturing operations while it owned the site. Expenses to remedy older contamination are non-deductible capital expenditures.[4]

To the extent you determine that some or all of the expenses in are allowable under section 162, that portion of the expense may qualify for specified liability loss treatment under section 172(f). In order for section 172(f) to apply, must show three things. First, it must have paid the expense pursuant to a federal or state environmental liability. Based on the facts you have presented, we believe has satisfied this first test. Second, the act or omission giving rise to the liability—the act or omission causing the contamination—must have occurred at least three years before the beginning of the taxable year. Finally, must have used an accrual method of accounting throughout the period in which it was

[4] When a taxpayer incurs capital expenditures, those amounts are added to the property’s basis and recovered through depreciation or on a sale or exchange. Here, though, agreed to transfer ownership of the site to in . If no longer owns the property, it would be entitled to a full deduction for all remediation expenses otherwise capitalized under section 263.

contaminating the site. Again, section 172(f) applies only to allowable deductions; it applies neither to non-deductible expenses incurred in nor amounts not yet incurred under the all-events and economic performance rules.

B. Economic performance does not occur as funds the policies.

has argued that its exit strategy arrangement should be considered "insurance" for federal income tax purposes. contends that it is entitled to an immediate deduction of the entire $ paid in , because the liability was incurred, in the case of insurance provided to the taxpayer, as the taxpayer pays the person to whom the liability is owed. Treas. Reg. § 1.461-4(g)(5). argues that it purchased insurance from , for which it paid in full in .

We disagree for two related reasons. First, did not purchase insurance. Second, the liability runs from to , not from to .

i. did not purchase insurance.

There are two reasons exit strategy is not "insurance" for federal tax purposes. First, should not be viewed as the purchaser of the "insurance policies" underwritten by . funded these policies because its Liability Transfer Agreement with required it to do so. funding of these policies was both a precondition of performance under the Agreement and sole compensation to under the Agreement. In addition, is named insured on both of the policies. $ payment in is compensation to , which , through the Liability Transfer Agreement, required to pay to .

Second, the Liability Transfer Agreement does not comport with the definition of "insurance" for tax purposes, which requires both transfer and distribution of an insurance risk. An insurance risk is the risk of a fortuitous loss. See, e.g., AMERCO and Subsidiaries v. Commissioner, 96 T.C. 18, 38 (1991); Rev. Rul. 89-96, 1989-2 C.B.114. There is no risk of fortuitous loss in the Agreement—the events giving rise to CERCLA liability already had occurred in . There exists no evidence that distributes any risk of loss over a large pool of insureds. The Liability Transfer Agreement simply is a pre-paid services contract. It bears none of the common attributes of an insurance contract.

ii. liability for payment runs to , not .

It is clear that the Liability Transfer Agreement is not insurance. But if the policies, or some portion of them, constitute insurance purchased by , cannot deduct the entire $ payment in as an insurance premium. The general rule for economic performance of insurance premiums is that, in the case of insurance provided to the taxpayer, amounts are incurred as the taxpayer pays the person to whom the liability is owed. Treas. Reg. § 1.461-4(g)(5). But obligation to pay anything to arose under the Liability Transfer Agreement, "made by and between . . . and " at section , page .

owed no liability to , so it cannot satisfy the general economic performance rule for insurance premiums by transferring money directly to . The Regulations state:

> Instead, economic performance occurs as payments are made from that other person or fund to the person to which the liability is owed. The amount of economic performance that occurs as payment is made from the other person or fund to the person to which the liability is owed may not exceed the amount the taxpayer transferred to the other person or fund.

Treas. Reg. § 1.461-4(g)(1)(i). Therefore, economic performance occurs, in the event that some or all of the policies constitute insurance, as makes payments to .

II. Insurance and the Deductibility of Insurance Premiums

Although we believe the operative contract for determining allowable deduction is the Liability Transfer Agreement, has argued that we should look to the policies and determine allowable deduction relative to those purported insurance contracts. Notwithstanding our position that these policies are not insurance purchased by , we discuss briefly why also fails to show it is entitled to an immediate deduction of the $ on the theory that these policies are insurance for federal tax purposes.

A. What is Insurance?

Neither the Code nor the Regulations define the term "insurance." Section 1.162-1(a) of the Regulations states that insurance premiums generally are deductible, but it does not describe how to differentiate between an insurance policy and a non-deductible self-insurance reserve. Helvering v. Le Gierse held that mere investment risk is insufficient to make a policy "insurance" for tax purposes, and the Court listed certain factors as common indicia of "insurance." 312 U.S. 531, 539-42 (1941). These factors include insurance risk at the time of the contract, risk shifting, risk distribution, and whether the contract comports with commonly-accepted notions of insurance. Id. at 539.

In cases subsequent to Le Gierse, courts used these four factors to determine whether an arrangement constituted insurance for tax purposes. In AMERCO and

Subsidiaries v. Commissioner, the Tax Court described "insurance risk" as the existence of some "hazard." 96 T.C. 18, 38 (1991). "If the parties structure an apparent insurance transaction so as to effectively eliminate the effect of insurance risk therein," stated the court, "insurance cannot be present." Id. Where "the only risk present in the transaction '[is] an investment risk similar to the risk assumed by a bank; it [is] not an insurance risk.'" Id. (citing Le Gierse, 312 U.S. at 542).

Risk shifting is the transfer of the insurance risk to a third party. Steere Tank Lines, Inc. v. United States, 577 F.2d 279, 280 (5th Cir. 1978). If the "insured" party retains the risk of loss, that party has established a non-deductible self-insurance reserve, not an insurance policy. Id. In Steere Tank Lines, the taxpayer paid to an insurance company an amount deposited into a "contract premium account" out of which all claims against it were paid. Id. Even though the taxpayer transferred these funds to an independent third party administrator, it still retained the ultimate risk of loss for these funds, and the court held the arrangement was not insurance. Id. at 280-81.

The concepts of insurance risk and risk shifting are the most important to any purported insurance contract, as the risk transferred must be risk of economic loss. Allied Fidelity Corp. v. Commissioner, 572 F.2d 1190, 1193 (7th Cir. 1978). The risk must contemplate the fortuitous occurrence of a stated contingency, Commissioner v. Treganowan, 183 F.2d 288, 290-91 (2d Cir. 1950), not merely an investment risk. Le Gierse, 312 U.S. at 542; see also Rev. Rul. 89-96, 1989-2 C.B. 114. Insurance in its commonly-accepted sense is not a mechanism to manage losses that are at least substantially certain to occur. This principle has various labels—fortuitousness, for example—and "embod[ies] the concept that one may not obtain insurance for a loss already in progress, or for a loss that the insured either knows of, planned, intended, or is aware is substantially certain to occur." 43 Am. Jur. 2d Insurance, § 479 (2005). The "insured" must transfer this risk of fortuitous loss to a third party insurer. If either the fortuitous risk of loss or the transfer of that risk is absent, the arrangement is not insurance for tax purposes.

Risk distribution is a pooling principal where the risk inherent in any one insurance contract is shared among insureds. Sears, Roebuck & Co. v. Commissioner, 96 T.C. 61, 101 (1991), aff'd in part and rev'd in part, 972 F.2d 858 (7th Cir. 1992). The Tax Court has described the benefits of pooling risks: "pooling increases the predictability of loss and thus increases reliability in establishing premiums and estimating appropriate reserves." Id. Therefore, a large pool of insureds makes it more likely that the insurance company can cover losses, even catastrophic losses, out of premiums paid. Id.

Finally, courts give little discussion to whether an arrangement comports with "commonly-accepted notions of insurance." In Sears, for example, the Tax Court asked whether the contract was characterized as insurance for "essentially all nontax purposes." Id. The court also "considered separateness of the corporate entities, the form and the substance of the transactions, and the relationship between the taxpayers." Id. at 102. In Le Gierse, the Supreme Court looked to the "usual" attributes of life insurance. 312 U.S. at 540.

B. When are insurance premiums deductible?

Although insurance premiums generally are deductible under I.R.C. section 162 and section 1.162-1(a) of the Regulations, there exist complex questions of timing: whether the deduction is allowable during the taxable year, or, in the case of a multi-year policy, amortized over the term of the policy. A taxpayer using the accrual method of accounting may deduct expenses in the taxable year in which all the events have occurred that determine the fact of the liability, the amount of the liability can be determined with reasonable accuracy, and economic performance occurs. Treas. Reg. § 1.461-1(a)(2). I.R.C. section 461(h) states that economic performance occurs, in the case where services are provided to the taxpayer by another person, when such person provides such services. I.R.C. § 461(h)(2)(A)(i). In the case of insurance contracts, economic performance occurs as premiums are paid. Treas. Reg. § 1.461-4(g)(5).

A premium expense may be deductible during the taxable year if it is (1) paid or incurred during the taxable year, (2) paid or incurred for carrying on a trade or business, (3) is "ordinary," and (4) is "necessary." Commissioner v. Lincoln Savings and Loan Ass'n, 403 U.S. 345, 353 (1971). "Ordinary" in this context means an expense that is normal, usual, or customary in the trade or business. Id. "Necessary" means that the expense is appropriate and helpful for the development of the taxpayer's business. Id. The Court in Lincoln Savings distinguished "ordinary" deductible expenses from non-"ordinary" non-deductible expenses, holding that because the expense in that case created a separate and distinct asset, the payment was a non-deductible capital, not ordinary, expense. Id. at 354.

The Supreme Court's opinion in INDOPCO, Inc. v. Commissioner further clarified the difference between deductible and capital expenses. In holding that corporate restructuring expenses were capital, not ordinary, expenses, the Court clarified that expenses directly related to future "permanent improvements or betterments" must be capitalized. 503 U.S. 79, 88-9 (1992) (citing I.R.C. § 263(a)(1)). After INDOPCO, there are two broad categories in which expenses must be capitalized: 1) expenses that create or enhance a separate and distinct asset, and 2) expenses that are directly related to a significant future benefit. In emphasizing the future benefit aspect of its inquiry, the Court noted that expenses need not create a separate and distinct asset (as in Lincoln Savings) to be capital in nature. Id. at 86-7.

The question of whether an arrangement is "insurance" is important because an arrangement must qualify as "insurance" for the premiums to be deductible. A self-insurance reserve is not deductible because the taxpayer has established a separate and distinct asset, Spring Canyon Coal Co. v. Commissioner, 43 F.2d 78, 80 (10th Cir. 1930), and, in many cases, the all events and economic performance tests for accrual taxpayers have not been satisfied. If the taxpayer retains the risk to avoid paying an insurance premium, "the statute does not permit [him] to deduct an amount which he fears he may someday be called upon to spend . . . ." Id. at 79. But if the arrangement is insurance with a term exceeding one year, there may be a significant future benefit.

The Regulations require that prepaid insurance premiums for policies covering more than one year must be capitalized. Example 1 of section 1.263(a)-4(d)(3) of the Regulations specifically addresses prepaid insurance. In Example 1, N corporation pays the entire premium upfront for an insurance policy with a three year term. N must capitalize the premium expense because it is a prepaid expense. Similarly, if payment on a multi-year policy is made before the final year of the policy, the economic performance Regulations require capitalization. Cf. Treas. Reg. § 1.461-4(g)(8), Ex. 6 and § 1.461-4(g)(8), Ex. 5. In Example 6 of section 1.461-4(g)(8) of the Regulations, Y contracts with Z insurance company for a policy that covers liabilities occurring during the next two years. Y pays Z before the end of the first year of coverage. Because the policy provides benefits beyond the first year, the premium is not deductible in year 1. However, in Example 5, V contracts with W insurance company for multi-year insurance coverage, but the policy allows V to pay the premium at any time up to one year after coverage ends. V pays after coverage ends and is entitled to an immediate deduction, because at the time V paid the premium, there were no future benefits.

Welch v. De Blois is one of the first reported cases on the deductibility of insurance premiums. The De Blois court held that premiums for multi-year prepaid insurance are deductible in the year paid. 94 F.2d 842, 843-4 (1st Cir. 1938). The court reached this result in part because it was customary for businesses in the taxpayer's trade to purchase multi-year policies to obtain lower premiums. Id. at 842-3. The court also reasoned that if insurance premiums must be amortized, expenses for other "ordinary" expenses would have to be amortized, even though they are not capital expenditures in the "normal" sense of the phrase. Id. at 844.

In Commissioner v. Boylston Market Association, the same First Circuit court (albeit a different panel) opined that De Blois was wrongly decided and should be overruled. 131 F.2d 966, 968 (1st Cir. 1942). The Boylston Market court held that prepaid insurance premiums for a policy covering more than one year must be capitalized. Id. at 967-68. The court stated:

> To permit the taxpayer to take a full deduction in the year of payment [for a capital asset] would distort his income. Prepaid insurance presents the same problem and should be solved in the same way. Prepaid insurance for a period of three years may be easily allocated. It is protection for the entire period and the taxpayer may, if he desires, at any time surrender the insurance policy. It thus is clearly an asset having a longer life than a single taxable year.

Id. The court therefore seemed unmoved by circumstances such as the "normal" practice of prepaying for multi-year insurance set out in De Blois.

The Eighth Circuit, in Waldheim Realty & Investment Co. v. Commissioner, disagreed with the Boylston Market reasoning and held that prepaid insurance premiums for multi-year policies are deductible in the year paid. 245 F.2d 823, 826 (8th Cir. 1957). In Waldheim Realty, the taxpayer, a real estate investment firm (much like the taxpayers in De Blois and Boylston Market) prepaid for multi-year insurance coverage, deducting the premiums in the year paid. Id. 823-24. The court criticized the First Circuit's apparent reliance on a multi-year policy's salvage value in determining such policy was a capital asset. Id. at 825.

In a later Eighth Circuit case, though, the court held that premiums for a multi-year policy were not immediately deductible. Black Hills Corp. v. Commissioner, 73 F.3d 799, 807 (8th Cir. 1996). The premiums Black Hills paid for mine workers' compensation insurance were relatively constant over the years, even though most claims typically are not filed in mine insurance until the year the mine closes. Id. at 803, 800-01. The court held that this disparity essentially created a reserve in the earlier years, which was a separate and distinct asset that required capitalization. Id. at 806-07.

These cases, especially the disparities within the circuits, indicate that the question of when to capitalize an insurance policy is a factual question, which depends largely on the facets of each policy. If the "premium" is easily allocable among the term of years, or if it creates an upfront reserve, the cases suggest capitalization is appropriate. Further, the general principles of Lincoln Savings and INDOPCO suggest that premiums for prepaid, multi-year insurance are not deductible because the premiums either create a separate and distinct asset or directly relate to a benefit that extends beyond the taxable year.

C. The Remediation Cost Cap Policy is not "insurance."

The Remediation Cost Cap Policy ("CCP") that funded, although one contract, consists of two separate components: an "Experience Account" balance, from which expenses are paid, and an "insurance policy" ("Cost Cap Insurance") to cover costs in excess of the Experience Account. The total cost for the CCP was $, but the contract provides a separate funding breakdown for each component. The CCP allocates $ of the total purchase price to the Cost Cap Insurance and denotes $ as the initial Experience Account balance. However, we know of no authority that allows a single, integrated contracted to be broken into parts for purposes of analysis as an insurance contract. Nevertheless, we examine both the entire contract and its separate components; neither the contract as a whole nor its individual components constitute insurance for federal income tax purposes.

A detailed examination of the CCP shows that the contract is not insurance for federal tax purposes because the only risk assumed by is that the remediation costs will exceed the amount charged as a "premium," which is more in the nature of an investment risk. The Cost Cap Policy payment merely establishes a fund from which actual remediation expenses will be paid. has not assumed the risk of a fortuitous loss, because the environmental contamination already existed when funded the policy, and already was legally liable for the remediation costs. Unlike some of the losses covered by the Liability Policy, which we examine in detail below, the losses covered by the CCP largely were known at the time funded the contract.

The CCP covers "reasonable and necessary costs for remedial action" for a period of years. Remediation Cost Cap Policy, Contract, at . , as named insured (or , in default), must submit to progress and cost reports as the remediation progresses. For known pollutants, as defined in the contract, remedial action must begin and end during the -year contract term. For pollutants unknown at the inception of the remediation action, the policy covers only the pollutants discovered during the project term. The CCP also contains an endorsement that covers property damage resulting from pollution that occurred prior to the "inception date," as well as defense costs for bodily injury resulting from pollution that occurred prior to the "inception date," which is the first day of the remediation period, . Cost Cap Policy, Contract, at , . claimed expenses are paid first from the Experience Account, and then if the expenses exceed that account's balance, the insurer will pay the remainder up to $.

The CCP is not insurance because it does not contemplate the fortuitous occurrence of a stated contingency. The only coverage is for events that already have occurred, and the only "risk" is the possibility that the remediation expenses could exceed the actuarially-determined estimate. The IRS held that such a "retroactive insurance" contract is not insurance in Revenue Ruling 89-96, 1989-2 C.B. 114. In Revenue Ruling 89-96, the taxpayer, because of a catastrophe during Year 1, incurred bodily injury liabilities expected to exceed $130x. The taxpayer had casualty insurance coverage of $30x, so, in Year 1, the taxpayer purchased, for a premium of $50x, additional liability coverage in the amount of $100x. This additional coverage was to cover claims over $30x, and the taxpayer disclosed to the insurer all facts related to the catastrophe.

The Revenue Ruling holds that the additional $100x of liability coverage was not insurance because "the catastrophe has already occurred, and the economic terms of the contract demonstrate the absence of any transfer of risk apart from an investment risk." The insurance company's only risks were "(1) that it will be required to make payments with respect to a known loss earlier than expected and (2) that the available investment yield between the time of payment of the premiums and the time of payment of the claims will be lower than expected." The investment yield includes the amount of the premium, the tax saving resulting from the insurer's deduction for losses incurred, and the investment income earned on the account.

In this case, is liable for environmental remediation expected to cost about $. The events giving rise to that liability already have occurred. has not purchased "insurance," it has pre-paid for services to clean up the site and transferred the administration of that fund to . There is no fortuity in the CCP agreement. The only risk assumed by is that the remediation expenses will exceed the total premium collected of more than $, plus any investment income earned on the "float" and tax saving for loss deductions.

Even if we examine the CCP as two separate components, the Cost Cap Insurance and Experience Account, neither constitutes insurance for tax purposes. The Cost Cap Insurance portion fails to satisfy the insurance test for the same reason the entire CCP fails—there exists no possibility for a fortuitous loss. knows the liabilities faces with regard to the site, and the only risk to is that it underestimated the amount it needed to charge as a premium.

Treating the Experience Account as insurance is equally problematic. Although has transferred management of the Experience Account to a third party administrator, it does not necessarily follow that it also has transferred its remediation liability risk. <u>See</u> <u>Steere Tank Lines</u>, 577 F.2d at 279-80. remains a potentially responsible party under CERCLA despite its Liability Transfer Agreement with . Had established a fund like the Experience Account and held and administered it itself, the Experience Account clearly would be a non-deductible reserve. <u>See</u> <u>id.</u> The Experience Account is a separate pre-paid contract fund within the CCP from which remediation expenses are paid to the remediation contractor at certain performance intervals and therefore is analogous to the non-deductible "contract premium account" in <u>Steere Tank Lines</u>.

D. <u>The Environmental Site Liability Policy may be insurance</u>.

Although we believe that should be viewed as the purchaser of the Liability Policy, not , this policy may constitute insurance. The extent of the potential losses may not have been known or knowable at the policy's inception. It appears has assumed some financial risk for unknown, fortuitous losses.

E. <u>Neither of these "insurance policies" would be fully deductible in</u> .

Even if the Cost Cap Insurance and Liability Policy are insurance policies for tax purposes, the amounts transferred from to are not immediately deductible. Because prepaid the "premiums" and the contracts have terms of years and years, respectively, must capitalize the premium expenses under the rules of section 1.263(a)-4(d)(3) of the Regulations and <u>Boylston Market</u>. Under the broad principles of <u>INDOPCO</u> and <u>Lincoln Savings</u>, these expenses are capital expenditures. To permit an immediate deduction in for the full premium would distort income; the total premium cost may easily be allocated over the life of the contract. <u>See</u> <u>Boylston Market</u>, 131 F.2d at 967-68. There are no facts in this case suggesting, as in Welch v. De Blois, pre-paying for a multi-year policy up front to obtain a discount is necessary, or that capitalization would be difficult to accomplish. Instead, these policies provide protection for a finite period of years, much like the policies in Boylston Market, which clearly indicates that the taxpayer has acquired separate and distinct assets. These capital assets, insurance coverage, cover and future years and limit the exposure to the premium paid, a significant future benefit. The premiums for the policies therefore must be capitalized under I.R.C. section 263. See also Treas. Reg. § 1.263(a)-4(d)(3)(i) and (ii), Ex. 1.

F. None of the insurance premiums qualify for section 172(f) treatment.

Finally, the premium costs, if the policies constitute insurance, are not subject to I.R.C. section 172(f) because they were not paid on account of an environmental liability. Rather, the payment was made for insurance to limit the amount spent to remedy its environmental liabilities. The liability giving rise to the obligation to pay arose under the Liability Transfer Agreement, which occurred in the same taxable year as claimed deduction. See I.R.C. § 172(f)(1)(B)(ii).

G. Summary

We emphasize that we believe emphasis on characterizing its payment as one for "insurance" is incorrect. The proper analysis is to view the entire exit strategy as a pre-paid services contract. We nonetheless provided the information in this section as a reference because the taxpayer has argued that the transaction should be viewed as a purchase of insurance.

III. The "Insurance Company Service Fee" is not deductible in 2003.

According to , allocated $ of the $ payment as a fee to service the remediation program to completion. We see no evidence in any of the agreements that provide for this separate allocation. For this reason, any "insurance company fees" would instead fall under the total amount paid by for its pre-paid services contract with .

If the taxpayer or the insurance company provides documentation that shows this "fee" is a separate obligation from to , it would be a separate pre-paid services contract. This payment does not represent the transfer of any risk from to the insurance administrator. It merely is compensation to an agent, and as such generally is an ordinary and necessary business expense, deductible in the year of payment under section 162. However, because is paying for up to years of administration services, this expense should be characterized as pre-payment for services, much like prepayment to . This amount is deductible as provides administration services.

If, however, evidence shows this is a fee paid from to , none of it is deductible on income tax return.

Finally, this amount is not subject to section 172(f), because it was not paid “in satisfaction of a liability under a Federal or State law requiring . . . the remediation of environmental contamination.” I.R.C. § 172(f)(1)(B)(i)(IV). paid this “service fee” to compensate an agent’s handling of the remediation program, not to satisfy the liability set forth in the Consent Decree and ROD. In addition, the obligation to pay this amount (if separate from the Liability Transfer Agreement) arose in the same taxable year in which actually paid , which also precludes section 172(f) treatment. I.R.C. § 172(f)(1)(B)(ii)(I).

IV. Interest on Late Payment

represents that $ of the $ payment was interest on a late payment of the policy amounts. Under section 163, interest is a deductible business expense. Because this amount is not directly related to any remediation, the obligation arose pursuant to a contract between and , and it was paid in the same year the liability to pay it arose, it does not qualify for treatment under section 172(f). may deduct the payment of $ in as an interest expense.

<u>CASE DEVELOPMENT</u>

For all amounts that are currently deductible in the taxable year, we recommend you obtain substantiation of the amounts sufficient to show that they were incurred for a deductible expense. Specifically, you should examine a breakdown of the costs and activities covered by the costs, including the portion of the site investigation report and remediation action plan pursuant to which the remediation contractor conducted these activities. You should ensure that none of these expenses represent non-deductible expenses such as fines and penalties. For example, the following costs are eligible for section 172(f) treatment:

- Environmental site investigatory costs;
- Site preparation for clean up;
- EPA or state agency reimbursements for investigatory or remediation costs incurred;
- Excavation and disposal of regulated substances found at the site;
- Containment or encapsulation costs not subject to capitalization under section 263(a);
- Excavating, stockpiling, or transporting waste;
- Treatment of contaminated soil or water; or
- Future monitoring costs to assure success.

The following costs do not qualify under section 172(f):

- Remediation costs for contamination that occurred less than three years before the beginning of (the taxable year of the deduction);
- Current compliance costs;
- Fines or penalties;
- Any legal costs not specifically incurred in determining the amount of the remediation liability, including, but not limited to:
    - o Negotiating consent decrees;
    - o Defending against civil or criminal charges;
    - o Defending against third party claims;
- Any capital expenditure, including construction of ground water treatment facilities, wells, pipes, pumps, or other equipment.

We also recommend that you confirm that transferred ownership of the property to in . The taxpayer has provided a copy of the property transfer agreement, but you also should obtain evidence that (or someone other than) holds legal title to the property. If still holds legal title, we suggest additional factual development to determine the extent to which the property was contaminated when purchased it. may have records, such as documents it received at closing, or access to records indicating the extent of the contamination at the time it purchased the property. In addition, the ROD, Consent Decree, or other similar documents may describe the extent of the pre- contamination. Given the length of time owned the site and operated its manufacturing operations, we recognize it may be difficult to obtain reliable information about the extent of preexisting contamination. If you cannot obtain any evidence of this nature, we believe a reasonable allocation would be a fractional allocation based on the number of years has owned the property over the total number of years the property has been contaminated.

Finally, we recommend you ask the taxpayer whether it has received, expects to receive, or is entitled to receive any insurance proceeds related to the contamination at the site. To the extent the taxpayer receives insurance reimbursement, its allowable section 162 deduction is decreased.

Please call if you have any further questions.

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