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Legend

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This ruling responds to your letter dated October 18, 2000. The issue is whether, after Funds 1 through 33 consolidate into a number no fewer than V funds, the funds may deduct as "insurance" premiums under I.R.C. § 162 and section 1.162-1(a) of the Income Tax Regulations amounts paid by the funds to Mutual, an assessable mutual insurance company in which the Funds are the only customers.[1] Many of the funds requesting this advice are identical to the funds which requested and received a favorable ruling (PLR 9624028) with respect to this issue in 1996.

Facts

Each of Funds 1 through 33 is a trust or separate series of a trust organized as a business trust under the laws of State A or State B, and each trust is registered with the Securities and Exchange Commission as an open-end management investment company under the Investment Company Act of 1940 (1940 Act), presently set forth, as amended, at 15 U.S.C. § 80a-1 et seq. (2001). Each fund is a "money market fund," which differs from other types of mutual funds insofar as money market funds attempt to maintain a stable net asset value, typically at $1.00 per share. Each Fund is nominally associated with Name A, the term generally used to refer to the consolidated group owned by Company A. Despite the Funds' affiliation with Name A and Company

[1] Unless otherwise indicated, all section references are to the Internal Revenue Code of 1986, as amended and in effect during the years in issue, and to the accompanying regulations.

A, neither Company A nor its affiliates owns more than one percent of the outstanding shares of any of the Funds (except for one Fund in which entities affiliated with Company A own approximately three percent of the outstanding shares). For federal income tax purposes, each fund qualified as a regulated investment company (RIC) under subchapter M of the Code in its most recent taxable year, and expects to qualify as such in subsequent years.

In accordance with the diversification requirements of the Code and the 1940 Act, each fund holds securities issued by numerous issuers. Specifically, in order to qualify as a RIC, each fund must comply with the requirements of § 851(b)(4), which provides that if a fund invests more than 5 percent of its assets in the securities of a single issuer, the value of all such investments at the close of each quarter of the RIC's taxable year may not exceed fifty percent of the value of the RIC's total assets. Moreover, pursuant to Rule 2a-7 of the 1940 Act, each of the funds must comply with additional diversification requirements in order to qualify as "money market funds." See 17 C.F.R. § 270.2a-7 (2001). Particularly, 17 C.F.R. § 270.2a-7(c)(4)(i)(A) provides that a "taxable money market fund" or a "national municipal money market fund" must invest no more than 5 percent of its total assets in the securities of any issuer (other than U.S. Government securities and certain repurchase agreements and refunded securities), except that a fund may invest more than five percent of its assets in a single issuer of the highest credit quality for a period of three days. Due to these diversification requirements and each Fund's different investment objectives, as of Date 1, the Funds held approximately W securities attributable to X issuers.

The provisions of Rule 2a-7 of the 1940 Act also govern the character of the investments held in each Fund. Specifically, Rule 2a-7 generally limits the maturity of any security held by a money market fund to not more than 397 days and limits the dollar-weighted average of a fund's entire portfolio to 90 days or less. Rule 2a-7 also requires money market funds to invest only in securities of high credit quality. These requirements minimize the fund's exposure to interest rate fluctuations and risk of default.

The Funds at issue in this case fall into three categories: (1) taxable money market funds, which generally seek the highest income and invest in U.S. Treasury Bills, commercial paper, and certificates of deposit; (2) national municipal money market funds, which generally seek the highest level of federally tax-exempt income and invest in securities issued by states, municipalities, and other tax-exempt obligors; and (3) Single-state municipal money market funds, which generally seek the highest level of income that is tax-exempt both federally and in a specific state and invest in securities of issued by that state or its municipalities. Each Fund has an arm's length investment management agreement with one of Company A's subsidiaries, and any Fund's investments are subject to the supervision of the Fund's Board of Directors, a majority of which are independent. A Fund's Board of Directors is free to terminate its relationship with Company A at any time without penalty within 60 days of providing proper notice.

Despite the limitations imposed on fund investments by Rule 2a-7, there is no guarantee that a money market fund will retain a net asset value of $1.00 per share. In the mid 1990's, Name A, in order to prevent the net asset value of each of the Funds in question from declining below $1.00 per share, evaluated several approaches to providing the Funds with some form of loss coverage. After determining that quotes from unrelated third-party insurers were too expensive, Name A and the Funds decided to establish a mutual insurance company (Mutual), to insure the Funds against credit default risk on the securities held by the Funds. The proposed formation of Mutual was the subject of PLR 9624028.

Mutual was organized in Country A in Year 1. Although Company A provided an initial capital contribution to Mutual in exchange for a surplus note bearing a market rate of interest, Mutual had redeemed the note by Year 3. Mutual has no shareholders; rather, the Funds that are participating policyholders in Mutual each own a proprietary interest in Mutual. If Mutual is liquidated when it has a surplus, any Fund participating in Mutual at the time of its liquidation will divide the proceeds on the basis of their relative shares of premium payments to Mutual during Mutual's existence.

Mutual provides coverage to participating funds for losses attributable to nonpayment of principal or interest of the issuer of insurable assets held by the fund, or for losses attributable to the bankruptcy or insolvency of the issuer or credit enhancement provider of such insurable assets. "Insurable assets" are defined in the policy as securities that at the time of purchase of the fund meet the portfolio requirements of Rule 2a-7 of the 1940 Act, not including U.S. Treasury obligations or other securities backed by the full faith and credit of the U.S. Government. Loss events are covered only to the extent that the loss amount exceeds a% of a funds insurable assets, applicable on a per fund basis. Mutual also provides coverage to a fund's directors and officers (but not to Company A in its capacity as investment advisor) with respect to errors or omissions relating to covered loss events.

Mutual determines the aggregate premium that it will charge the Funds by obtaining quotes from unrelated third party insurers that provide identical coverage, and by discounting such quotes to reflect the cost savings inherent in Mutual's structure. The aggregate premium is then allocated to each participating fund on the basis of that fund's share of insurable assets, taking into account differences in the risk of loss events occurring with respect to the classes of assets in which a fund invests. For the policy year ending Date 1, Year 3, each participating fund's premium averaged approximately a% of the fund's net assets.

Mutual's policy with the Funds has an aggregate limit of $b. Mutual retains the first $c of liability, and reinsures the remaining liability ($b less $c) with unrelated third-party reinsurers. Each policy that Mutual has issued to the Funds has been assessable, i.e., each Fund is subject to an additional premium assessment in certain instances. Any such additional premium, which will be assessed only if Mutual has insufficient surplus to cover a loss, will be made to all participating funds in proportion to each Fund's share of premium payments, without regard to which Fund actually sustains a loss. The maximum aggregate annual amount of any additional premium assessment is two-and-one-half times the aggregate premiums written by Mutual.[2]

Since commencing operations, Mutual has not received a claim from a participating fund.

Law and Analysis

Section 162(a) of the Internal Revenue Code allows a deduction for all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on a trade or business. Generally, under § 162(a), a taxpayer may deduct premiums paid for insurance if directly connected with the taxpayer's carrying on of a trade or business. Section 1.162-1(a) of the Income Tax Regulations. Although the Code does not define the term "insurance," the United States Supreme Court has explained that to constitute "insurance," a transaction must involve "risk shifting" (from the insured to the insurer) and "risk distribution" (by the insurer). Helvering v. Le Gierse, 312 U.S. 531, 539 (1941). In this regard, amounts set aside by a taxpayer as a self-insurance reserve for anticipated losses are not deductible "insurance" expenses because risk is not shifted from the taxpayer. Therefore, these amounts are not deductible until the taxpayer actually pays or accrues the anticipated loss as appropriate, depending on the taxpayer's method of accounting. United States v. General Dynamics Corp., 481 U.S. 239, 243-44 (1987).

Where a taxpayer owns all or a portion of a company that putatively "insures" the taxpayer, the question of whether the transaction is treated as insurance for tax purposes depends upon whether the taxpayer has actually transferred risk of economic loss to the company. In Rev. Rul. 77-316, 1977-2 C.B. 53, three situations were presented in which a taxpayer attempted to seek insurance coverage for itself and its operating subsidiaries through the taxpayer's wholly-owned captive insurance

[2] Mutual has also received a guaranty from Company A backed by a letter of credit to advance proceeds to Mutual to cover losses insured by Mutual in an amount representing the difference between: (1) the amount of risk retained by Mutual and (2) the sum of Mutual's surplus and amounts Mutual can draw from additional premium assessments. Mutual pays Company A an arm's length fee for this guaranty. The sources of proceeds to pay the losses of insured funds, therefore, are: (1) Mutual's surplus; (2) additional premium assessments; (3) Company A's guaranty; and (4) reinsurance for losses in excess of $c.

subsidiary. The ruling explained that the taxpayer, its non-insurance subsidiaries, and its captive insurance subsidiary represented one “economic family” for purposes of the risk-shifting analysis. The ruling concluded that the transactions were not insurance to the extent that risk was retained within that economic family. Therefore, the premiums paid by the taxpayer and its non-insurance subsidiaries to the captive insurer were not deductible.

Rev. Rul. 78-338, 1978-2 C.B. 107, addressed whether the taxpayer, a domestic corporation that conducted petroleum operations throughout the world, could be insured by a foreign insurance company in which that taxpayer shared an ownership interest with 30 other unrelated corporations. The insurer only provided insurance for its shareholders and their affiliates, no shareholder’s individual risk coverage could exceed 5 percent of the total risks insured by the company, and no one shareholder had a controlling ownership interest in the insurer. The ruling concluded that the transaction between the taxpayer and the company was insurance, and that amounts paid by the taxpayer to the company were insurance premiums deductible under § 162. The ruling reasoned that, because the taxpayer and other insureds-shareholders were not economically related, each insured’s economic risk of loss could be both shifted to the company and distributed among the shareholders who comprised the insured group.

The Service further elaborated on the concept of risk distribution in Rev Rul. 88-72, 1988-2 C.B. 31. That ruling addressed a situation where a taxpayer entered into a putative “insurance” transaction with its wholly-owned subsidiary, which was also engaged in the business of issuing insurance contracts to the general public. The ruling concluded that the transaction at issue was not insurance for tax purposes, because the taxpayer could not truly shift the risk of economic loss to its wholly-owned subsidiary. The ruling reasoned that any loss covered under the agreement between the taxpayer and its subsidiary would reduce the net worth of the subsidiary, which would in turn reduce the net worth of the taxpayer. Regarding the subsidiary’s issuance of policies to the general public, the ruling explained that the subsidiary, by assuming large amounts of statistically independent risks, effectively distributed its potential risk exposure by increasing the predictability of the average loss that will be incurred by the subsidiary on each risk exposure unit. Distinguishing risk shifting from risk distribution, however, the ruling further explained that although the subsidiary’s assumption of risk from unrelated third parties resulted in increased risk distribution, it did not have the effect of shifting the taxpayer’s risks to the subsidiary.

The facts in Rev. Rul. 78-338 are different from the facts in Rev. Ruls. 77-316 and 88-72 insofar as the taxpayer in Rev. Rul. 78-338 owned only a portion of the insurer, whereas the taxpayers in Rev. Ruls. 77-316 and 88-72 owned 100 percent of the insurer. Where a taxpayer attempts to purchase insurance from an insurer in which the taxpayer owns less than 100 percent, risk shifting may be present despite the taxpayer’s ownership interest in the insurer because the taxpayer’s losses covered under the policy will not necessarily diminish dollar for dollar the value of the taxpayer’s ownership interest in the insurer. Rather, the taxpayer's losses will also affect each of the insurer's other owners in proportion to their ownership interest.

Relying upon Rev. Rul. 77-338, PLR 9624028 concluded that each Fund could deduct as insurance premiums under § 162 amounts payable (including additional premium assessments) to Mutual, despite the fact that each of the insured Funds owned a portion of Mutual. PLR 9624028 reasoned that none of the Funds owned a controlling interest in Mutual, and that Mutual would be accepting a large number of independent risks because the securities held by the Funds were attributable to many issuers. In the present case, we conclude that the proposed transaction remains within the scope of Rev. Rul. 78-338.[3] Particularly, we note that the proposed transaction will not reduce the number of independent risks that Mutual accepts, will not establish a controlling ownership interest in Mutual by any one Fund, and will not reduce the number of Fund shareholders who will benefit from the insurance arrangement between Funds and Mutual.

On the basis of the facts and representations set forth in the Funds' submission, we conclude with respect to Funds 1 through 33 as follows:

> The fact that Mutual has no owners or policyholders other than Funds 1 through 33 and the fact that Funds 1 through 33 may consolidate into no less than V Funds, will not preclude each Fund from deducting as insurance premiums under I.R.C. § 162 and § 1.162-1(a) of the regulations amounts paid (including additional premium assessments) to Mutual.

The rulings contained in this letter are based upon information and representations submitted by the taxpayer and accompanied by a penalty of perjury statement executed by an appropriate party. While this office has not verified any of the material submitted in support of the request for rulings, it is subject to verification on examination.

Except as specifically set forth above, no opinion is expressed as to the tax treatment of the proposed transaction under the provisions of any other section of the Code or regulations.

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[3] Because the proposed transaction remains within the scope of Rev. Rul. 78-338, we are not prevented from ruling by Rev. Proc. 2001-3, section 4.01(11), 2001-1 I.R.B. 111, 116, (Service will not ordinarily issue rulings addressing whether a proposed transaction involves the requisite risk shifting and risk distribution to be considered insurance for purposes of determining the deductibility of amounts paid (premiums) by a taxpayer, unless the facts of the transaction are within the scope of Rev. Ruls. 77-316 or 78-338).

This ruling is directed only to the taxpayer(s) requesting it. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

A copy of this letter must be attached to any income tax return to which it is relevant.

Sincerely,
Lon B. Smith
Acting Associate Chief Counsel
(Financial Institutions and Products)
By: Mark Smith
Chief, Branch 4