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DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR ASSOCIATE DISTRICT COUNSEL

FROM: DEBORAH A. BUTLER
ASSISTANT CHIEF COUNSEL (FIELD SERVICE)
CC:DOM:FS

SUBJECT: Amounts paid for guaranty

This Field Service Advice responds to your memorandum dated August 2, 1999, and to your e-mail providing supplemental facts dated November 1, 1999. Field Service Advice is not binding on Examination or Appeals and is not a final case determination. This document is not to be cited as precedent.

LEGEND

Taxpayer =
B =
C =
D =
E =
F =
G =
H =
J =
K =
Date 1 =
Date 2 =
Date 3 =
Date 4 =
Date 5 =
Date 6 =
Date 7 =
Date 8 =

Year 1	=
Year 2	=
Year 3	=
Year 4	=
Year 8	=
Country A	=
State A	=
$a	= $
$b	= $
$c	= $
$d	= $
$e	= $
f	=
v%	= %
w%	= %
x%	= %

ISSUES

(1) Whether amounts paid by Taxpayer to its parent company, B, purportedly in consideration for the following two guarantees qualify as insurance premiums deductible by Taxpayer: (a) B's guaranty to an unrelated third party, K, that Taxpayer's subsidiaries, C and D, would meet their obligations to contribute amounts to a limited partnership in which C, D, and K were limited partners; and (b) B's guaranty to Taxpayer's subsidiary, E, that Taxpayer would meet its obligation to repay a loan from E.

(2) Whether either of these guarantees should be considered shams.

CONCLUSIONS

On the basis of the facts presented, the purported guarantees do not involve sufficient risk shifting to be considered insurance. Accordingly, the payment by Taxpayer to B does not qualify as a deductible insurance premium. Moreover, it appears that because the price paid for the guarantees was excessive, and because the payment appears to be lacking a non-tax business reason, we also conclude that the transaction are shams. We note, however, that because the facts in this case are not fully developed, our conclusions may change if additional facts are established. In this regard, we have set forth, infra, additional areas of potential factual development, and we encourage you to seek further advice, if appropriate.

FACTS

Taxpayer is the U.S. subsidiary of B, a corporation domiciled in Country A. On Date 1, Year 1, Taxpayer and B entered into a "Memorandum of Understanding" (MOU) regarding their participation in a project to develop a power plant in State A. The MOU provided that Taxpayer and B would participate in the development of the project with F, an unrelated energy company. The MOU further provided that since the project was a "high risk profile project," Taxpayer would promote the project by providing a "development fund" through a special purpose corporate subsidiary. In exchange for this, Taxpayer or its special purpose subsidiary would receive a return on any money lent, in addition to a "development fee."[1]

The MOU also provided that B would furnish a "back-up guaranty" for Taxpayer's "equity contribution" obligation to the project, and would arrange the source of the funds for the equity contribution to the project made by Taxpayer's special purpose subsidiary. In exchange for this, the MOU provides that B would receive any equity distribution rights from the project which the special purpose subsidiary is entitled to receive. Lastly, the MOU provided that Taxpayer or its special purpose subsidiary had the option to request that B transfer the equity distribution rights back to Taxpayer or the special purpose subsidiary, at fair market value, when the project was completed.

On Date 2, Year 2, F's two subsidiaries, H and J, formed G, a limited partnership through which the proposed power plant would be constructed and operated. H was the general partner. On Date 3, Year 2, Taxpayer and H executed the "Joint Development Agreement." As part of this agreement, Taxpayer agreed to lend $a to G. To make the loan to G, Taxpayer in turn borrowed money from E, one of Taxpayer's subsidiaries which is used to fund B's projects in the U.S. According to your e-mail dated November 1, 1999, Taxpayer maintains that B guaranteed repayment of Taxpayer's obligation to E. The "Joint Development Agreement" also required Taxpayer to provide equity funding, upon completion of the project, in an amount no greater than v% or the project cost, at a maximum amount of $b. B agreed in writing to furnish to K, an unrelated entity which provided the primary source of funding for the project, a guaranty for this equity funding.

On Date 4, Year 2, Taxpayer formed two domestic corporate subsidiaries, C and D, for the purpose of participating in the project. On Date 5, Year 2, C became a w% limited partner in G, and D became a x% limited partner in G. C and D made an initial capital contribution to G in the amount of $c. Moreover, C and D received a

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[1] It is unclear whether the parties anticipated that this "development fund" would consist of loans, equity contributions, or both.

line of credit from E, one of Taxpayer's other subsidiaries, in the amount of $b. In consideration, E received the rights to v% of the income from G (the equity rights). E thereafter transferred the equity rights to B.

On Date 6, Year 3, Taxpayer indicated to B that it wished to purchase from B the equity rights B had received from E, Taxpayer's subsidiary. Two months later, E, on behalf of Taxpayer, made a payment to B for these rights, purportedly for fair market value, in the amount of $d. On Date 7, Year 4, C and D fulfilled their obligations to provide equity funding to G by making a payment to G in the total amount of $e; apparently, C and D used their line of credit from E to make this payment.

As explained in your e-mail dated November 1, 1999, and by IDR # f, Date 8, Year 8, Taxpayer maintains that the payment it made to B in the amount of $d was in consideration for the following two "guarantees" made by B: (1) B's guaranty to K that C and D would meet their obligations to make equity contributions to G; and (2) B's guaranty of Taxpayer's obligation to repay E for amounts borrowed by Taxpayer. Consequently, Taxpayer argues that the payment is deductible as an insurance premium.

LAW AND ANALYSIS

(1) Whether the transactions are "insurance"

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. Treas. Reg. § 1.162-1(a). Although the Internal Revenue 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). The Tax Court has defined the term "insurance contract" as follows:

> In common understanding, an insurance contract is an agreement to protect the insured (or a third-party beneficiary) against a direct or indirect economic loss arising from a defined contingency. The insurer undertakes no present duty of performance but stands ready to assume the financial burden of any covered loss. An essential feature of insurance is this assumption of another's risk of economic loss.

Allied Fidelity Corp. v. Commissioner, 66 T.C. 1068, 1074 (1976) (citation omitted), affd. 572 F.2d 1190 (7th Cir. 1978).

In this case, the purported "insurance" contracts are guarantees by B that its subsidiaries will meet certain obligations. In United States v. Home Title Ins. Co., 285 U.S. 191 (1932), affg. 50 F.2d 107 (2d Cir. 1931), the Supreme Court of the United States addressed whether a taxpayer which issued many loan guarantees should be treated as an insurance company for Federal tax purposes. In Home Title, the taxpayer made loans secured by mortgages on real estate. The taxpayer then sold the notes to third parties, accompanied by the taxpayer's guarantee to the purchaser of the note that payments of principal and interest would be made. The premium paid for the guaranty equaled the "spread" between the interest rate paid by the debtor to the taxpayer and the interest rate paid by the taxpayer to the purchasers of the notes.

The Court concluded that the taxpayer was taxable as an insurance company. In reaching its conclusion, the Court reasoned that the guaranty of a debtor's payment of principal and interest on a loan constitutes "insurance." 285 U.S. at 195. The Court implicitly accepted the determination of the United States Court of Appeals for the Second Circuit that the risk transferred pursuant to these guarantees is the risk of noncollection from the debtor.[2] See 50 F.2d at 109. Consequently, because the taxpayer's principal business was issuing such guarantees, the taxpayer was taxable as an insurance company.

Although the opinion in Home Title supports the notion that a guaranty may constitute an insurance contract, the guaranty must otherwise result in sufficient risk shifting before it can be considered "insurance." Since insurance must involve the transfer of risk, "[i]mplicit in the concept of insurance is that the loss occur as the result of events that are fortuitous, rather than planned, intended, or anticipated." Lee R. Russ, 7 Couch on Insurance § 102:7 (3d ed. 1996). In this regard, the court in United States v. Tilleraas, 709 F.2d 1088, 1091 (6th Cir. 1983), explained: "Insurance is a contract where one undertakes to indemnify another against loss, damage or liability caused by an unknown or contingent event." See

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[2] Under the Second Circuit's analysis, the guarantor is the "insurer," and the party purchasing the note is the "insured." Typically, a debtor whose obligation is guaranteed is not "insured" because the guarantor has the right of subrogation against the debtor if the guarantor is required to perform under the guaranty. See 38 Am. Jur. 2d Guaranty § 120. In Home Title, the Second Circuit explained that the risk shifted from the purchaser of the note to the guarantor was the risk of noncollection from the debtor. The court further explained that it was irrelevant that the debtor, rather than the purchaser of the note, actually paid the insurance premium. See 50 F.2d at 110.

also, e.g., Gencorp, Inc. v. American Int'l Underwriters, 178 F.3d 804, 816-817 (6th Cir. 1999) (noting that fortuitous loss is implicit in concept of insurance); Diocese of Winona v. Interstate Fire & Cas. Co., 89 F.3d 1386, 1392 (8th Cir. 1996) (recognizing "fundamental premise" that insurance protects an insured from fortuitous loss). The principle that a contract constitutes "insurance" only where it provides coverage for fortuitous events is not only set forth in case law; several states have codified this requirement. For example, N.Y. Ins. Law § 1101(a) (McKinney 1999) provides:

> (1) "Insurance contract" means any agreement or other transaction whereby one party ... is obligated to confer benefit of pecuniary value upon another party ... dependent upon the happening of a fortuitous event ....
>
> (2) "Fortuitous event" means any occurrence or failure to occur which is, or is assumed by the parties to be, to a substantial extent beyond the control of either party.

Moreover, Cal. Ins. Code § 22 (West 1999) provides:

> Insurance is a contract whereby one undertakes to indemnify another against loss, damage, or liability arising from a contingent or unknown event.

(a) Whether B's guaranty of C's and D's obligations to G is insurance

We turn to the question of whether B's guaranty of C's and D's obligations resulted in sufficient risk transfer to be considered insurance. C and D were obligated to provide capital to G, and B guaranteed that this capital would be provided. Taxpayer, by characterizing this transaction as insurance, implicitly argues that the risk of C's and D's insolvency was transferred from G (and G's other investors) to B.

At the time that C and D were obligated to provide capital to G, C and D were special purpose subsidiaries which had no sources of funds other than in the form of capital contributions from either Taxpayer or B. Accordingly, B could willingly "create" the loss event covered by the guaranty by failing to adequately capitalize C and D. Since B had complete control over whether C and D were able to meet their obligation to G, the event covered by the guaranty was not "fortuitous" from B's standpoint. Therefore, the guaranty does not involve sufficient risk shifting to constitute "insurance."

In addition, prior to the execution of the guarantees in issue, B was already

responsible for the risks underlying those guarantees. As reflected by the MOU, it was contemplated at the outset of the project, prior to formation of C and D, that B would be ultimately liable to G for B's subsidiaries' "obligations" to finance the project. The other parties participating in the project were sophisticated; we doubt that such parties would enter into such a transaction without the understanding that B, rather than C and D, would be ultimately liable. Although C and D may have been nominally obligated to G, all of the parties involved in the project appeared to be aware that B ultimately bore that obligation. Cf. Plantation Patterns, Inc. v. Commissioner, 462 F.2d 712 (5th Cir. 1972) (controlling shareholder guaranteeing obligation of undercapitalized corporation treated as the primary obligor, rather than as guarantor). Consequently, the guaranty represents nothing more than B's affirmation of its pre-existing obligation to G. This factor also supports a conclusion that no risk shifted as a result of the guaranty.

(b) Whether B's guaranty of Taxpayer's obligation to E is insurance

We turn to the question of whether B's guaranty of Taxpayer's obligation to repay E resulted in sufficient risk transfer to be considered insurance. Taxpayer borrowed money from its subsidiary, E, and Taxpayer's parent corporation, B, guaranteed Taxpayer's repayment of the loan. Taxpayer, by characterizing this transaction as insurance, implicitly argues that the risk of noncollection from its indebtedness was transferred from its subsidiary, E, to B.

Since B owns directly or indirectly all of the stock of both Taxpayer and E, the risk of uncollectibilty under the note cannot be transferred to B. The value of Taxpayer's and E's stock is reflected on B's balance sheet. Regardless of whether Taxpayer meets its obligation to E, B will suffer no economic loss. Cf. Clougherty Packing Co. v. Commissioner, 811 F.2d 1297, 1305 (9th Cir. 1987) (purported insurance transaction between parent and wholly owned captive subsidiary does not result in risk shifting, because claims paid by the captive reduces, dollar for dollar, the value of the insurer's stock as reflected on the parent's balance sheet). Therefore, the guaranty does not involve sufficient risk shifting to constitute "insurance."

In addition, we note that B again has substantial control over whether the loss event will occur. From B's perspective, it appears that the loss event covered by the guaranty can be avoided if B adequately capitalizes Taxpayer. This factor also supports a conclusion that the guaranty does not result in risk shifting.

(2) Whether the transactions are shams

Furthermore, apart from whether either of the transactions were insurance, it

appears that the transactions lacked economic substance, and were motivated by tax, rather than business considerations.[3]

In this regard, we believe that the facts in this case are comparable to the facts set forth in the recent Tax Court opinion in United Parcel Service of America, Inc. v. Commissioner, T.C. Memo. 1999-268 ("UPS"). The taxpayer in UPS was a shipper which offered coverage to its customers for lost or damaged packages. The taxpayer charged its customers a fee, generating a large profit. The taxpayer then decided to shift these profits offshore. It accomplished this by finding a commercial insurance company to "insure" the risks of the taxpayer's customers, and a Bermuda corporation affiliated with the taxpayer then reinsured those risks from the commercial insurer. Thus, the profits were shifted from the taxpayer to the commercial insurer, which retained a small percentage, and then to the taxpayer's offshore affiliate.

The Tax Court concluded that the entire transaction was a tax motivated sham and an impermissible assignment of income. Accordingly, the court concluded that none of the amounts ultimately paid to the taxpayer's reinsurance affiliate were for insurance, although some "theoretical" risk had been transferred to the reinsurer. The court specifically discussed the vastly inflated price paid by UPS to the commercial insurer, relative to the remote risk transferred. The court noted that UPS would not have paid such an inflated price had the reinsurer not been affiliated with UPS.[4]

Similarly, the amount paid for the guarantees in this case seem excessive, and the payments seem to lack a business purpose. The guarantee payments represent a significant percentage of the underlying obligation; we question the business purpose of a payment for a guarantee which constitutes such a large portion of the underlying obligation. We doubt that Taxpayer would have made a payment in the amount of $d if B were not a related party. Furthermore, it is unclear how or whether Taxpayer and B attempted to determine the fair amount to pay for the risk purportedly transferred pursuant to the guarantees. Since B controlled the probability that the underlying loss events would occur, we question whether B could possibly make the determination of a "fair" premium to pay for the guaranty.

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[3] We note that since the purported guarantees do not involve risk shifting, the business purpose of any payments for such guarantees are inherently questionable.

[4] Importantly, the Tax Court in UPS relied upon common law sham principles to reject the entire transaction, and did not rely upon § 482 to reallocate a portion of the items in issue. In so doing, the court noted that the transaction was "heavily" tax motivated.

Business purpose appears to be particularly lacking with respect to B's guaranty of Taxpayer's obligation to E. Since the purpose of obtaining a guarantor for a loan is to either secure an otherwise unavailable loan, or to secure a loan on more favorable terms, it is unclear why E required such a guaranty before providing a loan to Taxpayer, its parent company. Again, we doubt that Taxpayer would have paid a guaranty fee to an unrelated guarantor to secure a similar loan from E.

We note that our conclusion that these guarantees are shams may change if additional facts are established. As mentioned infra, we suggest further factual development with respect to this issue.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

Our analysis does not discuss risk distribution, although such a requirement is typically necessary in order for a guaranty to be considered "insurance." Home Title, 50 F.2d at 110. We believe that such an approach in this case would be a red herring; a payment made to secure a guaranty could conceivably qualify as an ordinary and necessary expense under § 162, regardless of whether the party making the guaranty may distributes or pools the risks with other similar risks.

Furthermore we do not discuss this case in the context of the captive insurance analysis set forth in Rev. Rul. 77-316, 1977-2 C.B. 53. Neither of the guarantees at issue fit within the typical captive insurance fact pattern: B's guaranty of C's and D's obligation actually involve the risks of entities unrelated to B, such as K; and B's guaranty of taxpayer's obligation to E involves a parent insuring its subsidiaries, whereas the ruling involved a subsidiary insuring its parent. [redacted] and since we have concluded that the transactions lacked risk shifting without regard to the "economic family" theory set forth in Rev. Rul. 77-316, we see no reason to raise the ruling in our analysis.

Turning to areas of factual development, [redacted]

[redacted]

Lastly, we have been advised that this transaction, based on the facts as we know them, implicates important international tax issues, and accordingly, we advise you to coordinate with CC:INTL.

Please call if you have any further questions.

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By: JOEL E. HELKE, Chief
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