2012 Taxation of Financial Institutions

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Since 1987, Steptoe & Johnson LLP tax attorneys have presented the
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are presented in Section III of this document.

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1. Permanent Stock Form

a. Have both depositors and stockholders.

b. Upon liquidation, depositors are paid first (as creditors), then stockholders.

2. Mutual Form

a. Depositors are “members,” and deposits are “savings capital.”

b. Depositors cast one vote per $X of deposits, up to a maximum number of votes. Borrowers may, at some mutuals, be entitled to cast one vote per loan.

c. Upon liquidation, members are entitled to liquidation proceeds.

II. General Classifications of Banks

A. Commercial Banks

1. Banks generally issue demand deposits, and invest primarily in short-term business loans and government securities.

2. Includes Federal Reserve banks, national banks, and state bank and trust companies.

3. National banks are regulated by the Comptroller of the Currency and are members of the Federal Reserve System. State-chartered banks may be members of the Federal Reserve and are regulated by the FDIC if they have FDIC insurance.

4. Deposits are insured by the bank insurance fund (BIF) of the FDIC.

B. Thrift Institutions

1. Savings and Loan Associations (S&Ls)

a. Incorporated under state or federal law.

b. S&L associations may be in either stock or mutual form.

c. Federal S&Ls are regulated by the Office of Thrift Supervision (OTS).

d. Deposits are insured by the Savings Association Insurance Fund (SAIF) of the Federal Deposit Insurance Corporation (FDIC).

2. Mutual Savings Banks -- Located in New England states, these are state-chartered "cooperative banks" (i.e., non-profit mutual banks).

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III. Definitions

A. Definition of a "Bank"

1. Code section 581 definition

a. A "bank or trust company."

b. Incorporated and doing business under federal or state law. Treasury Regulation § 1.581-1 requires that a bank be a corporation for federal income tax purposes.

c. A "substantial part" of the business of which consists of:

(1) Receiving deposits, and making loans and discounts;

(2) Or, exercising certain fiduciary powers (See Rev. Proc. 2008-18).

d. Subject by law to supervision and examination (federal or state).

2. "Receiving Deposits"

a. U.S. v. Seattle First International Corp., 79-2 U.S.T.C. ¶9495 (D.-Wash. 1979) (entity that receives no deposits is not a bank).

b. <u>Morris Plan Bank of New Haven v. Smith</u>, 125 F.2d 440 (2d Cir. 1942) (bank that receives installment payments on certificates of indebtedness receives deposits).

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5. The definition of "banks" includes thrift institutions. Section 581.

B. <u>Definitions of Thrift Institutions</u>

1. Definition of a "S&L Association"

a. Code section 7701(a)(19) provides three tests that must be satisfied. <u>See</u> Treas. Reg. § 301.7701-13A.

(1) The Supervisory Test: The association must be either (i) a federally insured institution or (ii) subject to federal or state supervision and examination.

(2) The Business Operations Test: The association must principally acquire the savings of the public and invest in loans. <u>See</u> Treas. Reg. § 301.7701-13A(c).

(a) The "savings" test is met if savings are acquired in accordance with regulations. Alternatively, more than 75% of deposits must be made by the general public, and not more than 25% of debt must consist of notes and bonds (rather than deposits).

(b) The "investing" test is met if more than 75% of gross income consists of interest on loans, etc.

(3) The Assets Test: At least 60 percent of assets must be "qualifying" assets, such as cash, government obligations,

and specific types of loans (generally, real property residential mortgage loans).

b. The purpose of the definition is to include only associations that primarily make real property mortgage loans.

c. Revenue Ruling 90-54, 1990-2 C.B. 270 (An entity chartered as a "bank" cannot qualify as an "S&L association"). See also, Barnett Banks, Inc. v. Commissioner, 83 T.C.M. (CCH) 16 (2002) (domestic building and loan associations that obtained bank charters prior to their acquisition held no longer entitled to use the reserve method of accounting for bad debts under section 593).

2. Definition of a "Mutual Savings Bank"

Code section 591(b) defines a mutual savings bank as a bank that issues capital stock and that is regulated under laws applicable to mutual savings banks.

C. Banks and thrifts are excluded from the definition of "personal holding company." Section 542(c)(2).

IV. Taxation of Banks

A. Introduction -- In general, banks are taxed under generally applicable rules, similarly to other corporations.

1. Accounting Rules Applicable to all Corporations

a. Section 446(a) provides that taxable income should be computed under the "method of accounting on the basis of which the taxpayer regularly computes his income in keeping his books" unless the method "does not clearly reflect income." In any such case, taxable income is computed under "such method as, in the opinion of the Secretary, does clearly reflect income."

b. The two major accounting methods are the cash method and the accrual method. Very few corporate taxpayers are permitted to use the cash method (a C corporation that has at least $5 million in annual gross receipts is prohibited from using the cash method of accounting). Section 448. Accordingly, this outline focuses on the accrual method.

c. Income -- Generally, under an accrual method, income is included for the taxable year when all the events have occurred that fix the right to receive the income and the amount of the income can be determined with reasonable accuracy (i.e., the "all events test").

(1) The all events test is modified with respect to debts that are subject to risks of uncollectibility.

(2) When a debtor becomes insolvent with the result that interest on the debt isn't collectible, interest must be accrued to the date of insolvency but not thereafter. This is true even though interest accrued during the same taxable year but before the date of insolvency is uncollectible. Rev. Rul. 80-361. Whether a debt is uncollectible is an area of dispute.

d. Deduction -- A liability is incurred, and generally taken into account for Federal income tax purposes, in the taxable year in which all the events have occurred that establish the fact of the liability, the amount of the liability can be determined with reasonable accuracy, and economic performance has occurred. Treas. Reg. § 1.446-1(c)(1)(ii)(A).

B. While banks are generally taxed as other corporations, Code sections 581 to 597 contain several special provisions that are specifically applicable to banks. Below, the following special provisions are discussed: bad debt deductions for losses on loans and special gain and loss provisions (includes worthless securities, worthless stock, and sales and exchanges of indebtedness).

C. <u>Bad Debt Deductions for Losses on Loans</u>

1. In general, the usual section 166 rules govern the bad debt deduction. Section 166 provides a deduction for any debt which becomes worthless within the taxable year. Whether a debt is worthless in whole or in part is a question of fact that must be determined from all the evidence, including the value of any collateral and the financial condition of the debtor. Treas. Reg §1.166-2(a). ¶

2. However, there are special rules for banks with respect to bad debt deductions.

3. Current rules

a. Small banks may (1) take a bad debt deduction by using the specific charge-off method, or (2) take a deduction under section 585 for a reasonable addition to a reserve for bad debts (the reserve method), computed using the experience method.

b. Large banks must use the specific charge-off method and do not have the option of using the reserve method.

4. The changing statutory scheme

   a. Banks have always had the option of using the specific charge-off method for bad debts in respect of loans.

   b. From 1986 to 1987, all banks could elect to use the reserve method for bad debts in respect of loans. After 1987, "large banks" were no longer permitted to use the reserve method; only small banks can use the reserve method.

   c. Under the reserve method, banks could use either the "percentage of loans" method or the "experience" method.

      (1) The percentage of loans method was phased out over the 18-year period from 1969 to 1987.

      (2) After 1987, under the reserve method, banks could use only the experience method.

5. The specific charge-off method

   a. Specific loans must be:

      (1) Determined to be worthless - Treas. Reg. § 1.166-2, and then

      (2) Charged off - Treas. Reg. § 1.166-3(a)(2).

   b. Two unique timing rules are available:

      (1) Treas. Reg. § 1.166-2(d)(1) provides that if a bank is required to charge off a loan, or if a bank charges off a loan and that action is confirmed on examination or audit, then worthlessness is conclusively presumed to have existed. <u>See</u> Rev. Rul. 81-18, 1981-1 C.B. 295, and Rev. Rul. 92-14, 1992-1 C.B. 93.

      (2) Treas. Reg. § 1.166-2(d)(3) provides a "conformity election," pursuant to which the treatment of bad loans on the bank's regulatory books conclusively determines the treatment of bad loans for tax purposes. <u>See</u> Rev. Proc. 92-84,1992-2 C.B. 489, regarding making this election. <u>See also</u>, Rev. Rul. 2001-59, 2001-51 I.R.B. 1, where the IRS concluded that a bank that elected this method of accounting for bad debts fell within the conformity rule despite having erroneously charged off certain credit card debts, because the bank's deduction for worthless debts was not "substantially in excess of the amount warranted

by reasonable business judgment under applicable regulatory standards."

6. The reserve methods available to banks

   a. Under the reserve method, a deduction is allowed for reasonable additions to a reserve for bad debts. Specific bad debts are not deducted, but are charged to the reserve.

      (1) Section 585 formerly provided two methods to determine the amount of the reserve addition under the reserve method: the percentage of loans method and the experience method.

         (a) As of 1986, a bank could use either method for any year. The maximum reserve addition was the greater of the amounts computed under the two methods. Section 585(b)(1). Treas. Reg. §-1.585-2(a)(1).

         (b) However, after 1987 "large banks" are no longer permitted to use the reserve method and "small banks" may only use the experience method (banks may no longer use the percentage method).

   b. The reserve methods can be used only for losses on "loans." In general, the term "loan" means debt as the term "debt" is used in section 166 and the regulations thereunder. Treas. Reg. § 1.585-2(e)(2). <u>See</u> LTR 8928002 (Mar. 22, 1989) and LTR 9423002 (Jan. 25, 1994) (interests in mortgage pools constitute "loans").

      (1) REMIC regular interests are "loans."

      (2) A bank that holds only servicing rights to mortgage loans owned by others may not include the loans in its balance of loans outstanding. LTR 200439041 (June 16, 2004).

   c. The allowable deduction under the reserve method is the amount necessary to increase the opening bad debt reserve (reduced by specific bad debts charged off during the year) to the maximum allowable ending bad debt reserve for the year.

7. The Percentage of Loans Method

   a. In general, and subject to exceptions, the reserve addition was the amount that increased the bad debt reserve to the "allowable percentage" of "eligible loans."

b. The allowable percentage was set by statute, and was phased out over a transition period:

1969-1976	1.8 percent
1976-1981	1.2 percent
1982	1.0 percent
1983-1987	0.6 percent

c. "Eligible loans" were a certain type of "loans," as defined in section 585(b)(4). See Treas. Reg. § 1.585-2(e)(3).

d. In 1987 and subsequent years, the percentage method is no longer available.

8. The Experience Method

a. Prior to 1987, banks could elect to use the experience method. In 1987 and subsequent years, it is the only reserve method that is allowed (except for "large" banks). Section 585(b)(1).

b. The maximum reserve addition is the amount necessary to increase the reserve to the greater of (1) the "six-year moving average amount" or (2) the "base year amount."

c. The six-year moving average amount is the amount which bears the same ratio to current loans outstanding as (1) the total of (net) bad debts sustained for the current year and the preceding five years, bears to (2) the sum of the loans outstanding at the close of those same six years.

d. A period of less than six years may be used if there is a change in the type of loans outstanding such that the risk of loss on the loan portfolio is substantially increased. Treas. Reg. § 1.585-2(c)(1)(ii). See LTR 8425059 (Mar. 20, 1984), 8544030 (July 31, 1985), and LTR 8929061 (Apr. 26, 1989).

e. The base year amount is the lesser of (1) the reserve balance as of the close of the base year, and (2) if loans outstanding have decreased, the base year reserve balance proportionately reduced.

f. The base year is the year before the most recent election of the experience method. For years after 1987, the base year is 1987.

g. See Examples #1 and #2, infra.

9. Changes in reserve method

a. Prior to 1988, a bank could change back and forth between the percentage method and the experience method of determining the amount of the reserve addition. After 1987, however, the percentage of loans method is no longer available.

b. A bank must elect to use either the specific charge-off method or the reserve method. A change from one to the other is a change in method of accounting, and requires the consent of the Commissioner. <u>See</u> Treas. Reg. § 1.585-2(d); Rev. Proc. 2002-9.

10. Elimination of reserve method for "large" commercial banks

a. For taxable years after 1986, "large banks" are no longer allowed to use the reserve method for bad debts. They instead must use the specific charge-off method. Section 585(c). <u>See</u> Treas. Reg. §-1.585-5 through -8.

b. Definition of a "large bank"

(1) A "large bank" is a bank with assets the aggregate adjusted basis of which exceed $500 million. <u>See</u> Section 585(c)(2)(A); Treas. Reg. § 1.585-5(b).

(2) Assets of banks in a parent-subsidiary controlled group are aggregated for purposes of this test.

(3) Once a bank becomes a "large bank," it remains a large bank, even if its assets decrease to less than $500 million. Treas. Reg. § 1.585-5(b)(3), Example (2).

c. In 1987, or in any subsequent year in which a bank becomes a "large bank," existing bad debt reserves must be either (1) "recaptured" or (ii) "run off."

d. Recapture of bad debt reserves

(1) In the year in which a bank becomes a "large bank," a change in method of accounting occurs, and the bank thereafter uses the specific charge-off method. <u>See</u> Treas. Reg. § 1.585-6.

(2) The balance of the bad debt reserve as of the close of the preceding year is brought into income over a four-year spread period:

Year 1 - 10 percent

Year 2 - 20 percent
Year 3 - 30 percent
Year 4 - 40 percent

(Year 1 is the year of change.)

(3) The bank may elect to include a larger portion in income in Year 1. If so, the remaining amount is included in income over the next three years to the extent of 2/9, 1/3, and 4/9 of the remaining amount, respectively.

(4) There will be no recapture for any year in which a bank is “financially troubled” (i.e., if the amount of its nonperforming loans exceeds 75 percent of its equity capital (assets less liabilities)). Recapture is merely suspended, and restarts when the bank is no longer troubled.

e. In lieu of recapturing its reserves, a large bank may elect to “cut off” use of the reserve method for new loans, and “run off’ its existing reserves for old loans.

(1) Under this alternative, there is no change in method of accounting for the “pre-disqualification loans” and the bank continues to hold its bad debt reserve with respect to those loans. See Treas. Reg. § 1.585-7.

(2) Because the reserve covers only existing loans (loans held by the bank as of the first day that it becomes a large bank), only losses on those loans are charged against the reserve, and only recoveries on those loans are credited to the reserve, without being items of expense or income.

(3) Once the reserve balance reaches zero, further charge-offs with respect those loans may be charged off under the specific method.

(4) New loans are accounted for under the specific charge-off method.

f. See Example #3, infra.

D. Special Gain and Loss Provisions

1. Worthless Securities

a. Generally applicable rules to corporations:

(1) Bad debts typically are deductible under section 166.

(2) A special rule applies to "securities." Section 165(g)(1) provides that when a "security" which is a capital asset becomes worthless, the loss is deemed to result from a sale or exchange of the asset. See sections 165(f) and 1211 (limiting capital losses to the extent of gains) .

(3) Definition of "security"

– §165(g)(2)(A) - stock
– § 165(g)(2)(B) - warrants, etc.
– §165(g)(2)(C) - debt issued by a corporation or government, with interest coupons, or in registered form.

(4) As a corollary, section 166(e) provides that section 166 (Bad Debts) does not apply to section 165(g)(2)(C) debt "securities." [Note, section 165(g)(2)(A) and (B) debt "securities" do not fall within the definition of a debt under section 166. See Treas. Reg. § 1.166-1(c).]

b. Special rule for banks -- A special rule applies to banks for losses upon worthlessness of section 165(g)(2)(C) debt "securities":

Section 582(a) provides that losses on worthlessness of section 165(g)(2)(C) debt "securities" are deductible by banks under section 166 as bad debts.

c. In general, the usual section 166 rules govern the bad debt deduction.

d. The reserve method for bad debts (former section 166(c)) was repealed by the 1986 Act. (The section 585 reserve provisions do not apply to "security" debt. See Treas. Reg. § 1.585-2(e)(2)(ii); LTR 7921016 (Feb. 12, 1979).)

e. As a result, the specific charge-off method of section 166(a) applies. However, as discussed above, two unique timing rules are available.

(1) Treas. Reg. § 1.166-2(d)(1) provides that debts will be conclusively presumed to be worthless if ordered to be charged off by examining authorities, or if charged off in accordance with established policies and confirmed on subsequent audit or examination. Rev. Rul. 81-18, 1981-1 C.B. 295, and Rev. Rul. 92-14, 1992-1 C.B. 93, illustrate the operation of the conclusive presumption.

(2) Treas. Reg. § 1.166-2(d)(3) provides a "conformity election." See Rev. Proc. 92-84, 1992-2 C.B. 489, regarding making this election.

2. Worthless Stock

a. Generally applicable rules:

(1) Section 165(g)(1) states the general rule: when a "security" which is a capital asset becomes worthless, the loss is deemed to result from a sale or exchange of the asset.

(2) For ordinary corporations, section 165(g)(3) provides an exception for 80-percent owned domestic corporations, 90 percent of the income of which is from an active trade or business.

b. A special rule applies to losses upon worthlessness of affiliated bank stock:

Section 582(b) provides that if a bank holds at least 80 percent of stock in another bank, that stock will not be treated as a capital asset.

c. As to other stock held for investment purposes, under section 165(g)(1) the loss upon worthlessness is capital.

d. Treas. Reg. § 1.165-4 provides that if a bank is required to charge off stock, that action will be considered prima facie evidence of worthlessness.

3. Sales and Exchanges of Indebtedness

a. Generally applicable rule:

(1) A "sale or exchange" of a "capital asset" results in capital gain or loss. Sections 1001 and 1221.

(2) Mortgage loan "swaps" constitute dispositions of property that give rise to realized losses. Cottage Savings Ass'n v. Comm'r, 499 U.S. 554 (1991).

b. A special rule applies to banks:

(1) Section 582(c) provides that sales or exchanges of indebtedness shall not be considered sales or exchanges of capital assets. Thus, ordinary income and losses result from such sales and exchanges.

(2) Regular and residual interests in REMICs and regular interests in FASITs constitute "indebtedness" for purposes of section 582.

(3) Community Trust Bancorp v. U.S., 1999-2 USTC ¶ 50,698 - Section 582(c) does not apply to a bank's mutual fund losses where the mutual fund invests in debt securities.

c. Prior law rule, for pre-1969 indebtedness:

(1) Under prior law, sales and exchanges of indebtedness were accorded capital gain, ordinary loss treatment.

(2) This special treatment was repealed by the 1969 Tax Reform Act.

(3) A transitional rule providing grandfather relief, section 582(c)(2) to (4), was repealed by the 1990 Act.

V. Taxation of Thrift Institutions

A. Reserves for Losses on Loans

1. Thrifts are generally taxed in the same manner as commercial banks.

a. Thrifts can use the specific charge-off method, which is the same as that used by commercial banks.

b. Thrifts can use the reserve method.

(1) If a thrift is treated as a "large bank," it must use the specific charge-off method.

(2) Otherwise, the thrift can use the section 585 experience method (or the specific charge-off method).

(3) If a thrift becomes a "large bank," see IV.C.10, V.A.3, and Example #4.

(4) If a thrift becomes a "small bank," see Example #5.

2. Historical Background

a. Through 1995, section 593 controlled.

(1) Under section 593(c), a thrift had three reserves:

(a) The reserve for losses on "qualifying real property loans" (the "Q" reserve),

i) Qualifying real property loans are loans secured by an interest in improved real property or by an interest in real property which is to be improved out of the proceeds of the loan. Section 593(d)(1); Treas. Reg. § 1.593-11.

ii) Interests in certain REMICs can be qualifying real property loans. Section 593(d)(4).

iii) The Q reserve is computed using the percentage of taxable income method, or experience method.

(b) The reserve for losses on nonqualifying loans (consisting of all loans that are not qualifying real property loans) (the "non-Q" reserve),

i) The Non-Q reserve addition must be separately computed under the experience method. Section 593(b)(1)(A).

(c) The supplemental reserve (in general, no deduction is allowed for additions to this reserve).

(2) Losses on the various types of loans must be charged against the appropriate reserve. Recoveries on loans charged off as bad debts are credited to the appropriate reserve.

b. In the 1996 Small Business Act, section 593 was repealed, effective for years after 1995.

(1) Thus, the percentage of taxable income method, formerly allowed to thrifts, is not available after 1995. Section 593(f).

(2) Congress believed that use of the former method mismeasured economic income (by allowing deductions too soon), and provided thrifts with too great a benefit relative to banks.

(3) Beginning in 1996, thrifts are required to use a new method to determine their bad debt deductions.

(a) If the thrift is treated as a "large bank," it must begin to use the specific charge-off method.

(b) Otherwise, the thrift can utilize the section 585 experience method (or the specific charge-off method).

(4) This change in treatment is treated as a change in method of accounting. Section 593(g)(1).

(5) Ordinarily, the entire amount of the year-end 1995 bad debt reserve would have to be taken into account under the section 481 change in accounting method rules. However, special rules provide for some relief. Section 593(g).

(a) Until 1988, under financial accounting standards, deferred tax liabilities were not required for deductions attributable to the bad debt reserve method for thrifts. This treatment changed in 1988.

(b) If thrifts were required to "recapture" pre-1988 bad debt reserves, adverse financial accounting treatment would result. (This problem is not present for post-1987 reserve additions.)

(c) For this reason, Congress provided a partial "fresh start" with respect to pre-1988 bad debt reserve additions.

(d) The portion of the bad debt reserve not granted a "fresh start" (the portion attributable to post-1987 reserve additions) must be brought into income ratably over 6 years. Section 593(g)(1)(C).

3. Rules applicable to a thrift that is treated as a "large bank" and begins to use the specific charge-off method.

a. The full amount of the otherwise required section 481 adjustment (i.e., the amount of the year-end 1995 bad debt reserves) is not taken into account, but only the amount attributable to "applicable excess reserves."

b. "Applicable excess reserves" are the portion of the bad debt reserves attributable to post-1987 years, as follows (Section-593(g)(2)(A)):

(1) The balance of the Q and the non-Q reserves as of year-end 1995 are reduced by,

(2) The balance of the Q and the non-Q reserves as of year-end 1987 (the "pre-1988 reserves").

c. The applicable excess reserves must be brought into income ratably over a six-year period beginning with 1996.

d. Three special rules may apply to modify this treatment.

(1) In computing applicable excess reserves, the balance of pre-1988 reserves is proportionally reduced if the balance of loans outstanding as of 1995 is less than the balance as of 1988. Section 593(g)(2)(A)(ii)(1I).

(2) The timing of the recapture of the applicable excess reserves is delayed for a 1- or 2-year period if the thrift meets the "residential loan requirement." Section 593(g)(4).

(a) The requirement is met if the thrift continues to make residential mortgage loans in an annual amount at least equal to the average annual amount of such loans made during the period 1990-1995.

(b) Recapture can be delayed only for 1996 and 1997.

(c) If, during any year after 1995, the thrift ceases to be treated as a "bank," the pre-1988 reserves (and the supple- mental reserve) must be brought into income over a 6-year period. Section 593(g)(3).

4. Rules applicable to a thrift that is not treated as a "large bank" and begins to use the experience method.

a. An opening 1996 reserve is established under the experience method, and the amount of the otherwise required section 481 adjustment is limited to the "applicable excess reserves." Section 593(g)(2)(B).

b. "Applicable excess reserves" are the portion of the bad debt reserves attributable to post-1987 years, but excluding any portion of reserves included in opening reserves for 1996, as follows (Section 593(g)(2)(B)(i)):

(1) The balance of the Q and the non-Q reserves as of year-end 1995 are reduced by,

(a) The greater of:

i) balance of the Q and the non-Q reserves as of year-end 1987 (the "pre-1988 reserves"), and

ii) the opening 1996 bad debt reserves under the experience method.

(2) The applicable excess reserves must be brought into income ratably over a six-year period beginning with 1996.

(a) The amount of the opening 1996 reserve actually used under the experience method for 1996 is the "greater of" amount set forth in the second preceding paragraph. Section 593(g)(2)(B)(ii).

(3) The three special rules discussed above may apply to modify the required recapture treatment.

(4) If the thrift subsequently becomes a "large bank," the "pre-1988" reserves continue to receive the "fresh start" and are not recaptured. Section 593(g)(5).

B. Deduction for Dividends on Deposits

1. Section 591(a) allows mutual thrift institutions to deduct dividends or interest credited to depositors' accounts.

2. In the case of mutual associations, this provision allows the deduction of "dividends" credited to depositors' accounts. See Rev. Rul. 55-391, 1955-1 C.B. 306 (preferred stock dividends deductible as interest). Midwest Sav. Ass'n v. Comm'r, 75 T.C. 262 (1980).

3. Interest is deductible in the year in which it may be withdrawn on demand subject only to customary notice of intention to withdraw.

4. Note: The depositor treats such amounts as interest, not as dividends.

5. Stock associations are not allowed to deduct dividends paid or credited with respect to their stock.

6. Deductions not covered by section 591 (a) are subject to section 593(e). This provision prevents the thrift's shareholders from benefiting from the section 593 reserve method.

a. In general, distributions to shareholders are treated as first out of earnings and profits and second out of the reserve for losses on qualifying real property loans. In both cases, the distributions constitute ordinary income to shareholders.

b. In years after 1995, after the repeal of the section 593 bad debt reserve method, distributions to shareholders are treated as first out of earnings and profits and second out of "pre-1988" reserves. In both cases, the distributions constitute ordinary income to shareholders. Thus, in this shareholder context, there is no “fresh start” for pre-1988 reserves. Section 593(e).

VI. Proration Rules Applicable to Banks and Thrifts

A. Interest on bank deposits is deductible under section 163.

B. Section 265(a)(2) provides that interest on indebtedness incurred to purchase or carry tax-exempt obligations is nondeductible. Generally, this calls for a factual inquiry to determine the taxpayer’s intent.

C. Nevertheless, banks historically were permitted to invest deposited funds in tax-exempt obligations and deduct in full the interest paid to depositors. See, e.g., Rev. Proc. 70-20, 1970-2 C.B. 499.

D. However, over time, Congress has reduced the amount of the deduction. Applying the rules in sections 291 and 265 (both described in detail below) concurrently:

1. Bonds acquired before 1983 are not subject to proration.

2. Bonds acquired from 1983 to August 1986 are subject to 20% proration per section 291.

3. Bonds acquired post August 1986 are subject to 100% proration per section 265.

E. Proration Under Section 291

1. Section 291, enacted in TEFRA, reduced the amount of the deduction allowable with respect to “financial institution preference items” by 15 percent. The percentage was subsequently increased to 20 percent.

2. Financial institution preference items include:

   Tax-exempt related interest - Section 291(e)(1)(B) provides that interest that is incurred to purchase or carry tax-exempt obligations acquired after 1982 but before August 1986 is a tax preference item. (Note allocation rule-see below.)

3. Section 291 applies to tax-exempt obligations acquired after 1982, but before August 8, 1986.

4. With respect to such tax-exempt obligations, the amount of the deduction for interest on funds “allocable to” those obligations is reduced by 20-percent. Section 291(a)(3) and (e).

5. Interest "allocable to" such tax-exempt obligations is determined as follows (section 291(e)(1)(B)(ii)):

$$\frac{\text{interest allocable to tax-exempt obligations}}{\text{total interest deduction}} = \frac{\text{adjusted basis of such tax-exempt obligations}}{\text{adjusted basis of all assets}}$$

6. Section 1363(b)(4) precludes the application of Section 291 to a C corporation holding company if that company was not a C corporation for any of 3 preceding years. Vainisi v. Commissioner, 599 F.3d 567 (7th Cir. 2010).

7. See Example #6, infra.

F. Proration Under Section 265(b)

1. In the 1986 Act, the former 20-percent disallowance rule was replaced with a 100-percent disallowance rule.

2. With respect to tax-exempt obligations acquired after August 7, 1986, no deduction (for years after 1986) is allowed for interest on funds "allocable to" those obligations. Section 265(b)(1). See Rev. Rul. 90-44,1990-1 C.B. 54.

3. This rule applies in concert with (and following the application of) the usual section 265(a)(2) disallowance rule. Section 265(b)(6)(A).

4. Interest allocable to such tax-exempt obligations is determined as follows (section 265(b)(2)):

$$\frac{\text{interest allocable to tax-exempt obligations}}{\text{total interest deduction}} = \frac{\text{adjusted basis of such tax-exempt obligations}}{\text{adjusted basis of all assets}}$$

5. Certain "qualified tax-exempt obligations" ("QTOs") are excepted from the total disallowance rule of section 265(b)(1).

   a. These are certain obligations designated as qualifying under section 265(b)(3) by qualified small issuers.

   b. These obligations, instead, are subject to the section 291 20-percent disallowance rule.

6. <u>See</u> Example #7, <u>infra</u>.

7. Transitional rules

   a. The 100-percent disallowance rule applies to obligations acquired after August 7, 1986, in years after 1986. Thus, for example, an obligation acquired on August 15, 1986 is subject to the 20-percent disallowance rule for 1986, and the 100-percent disallowance rule for years after 1986.

   b. There is an exception for certain acquisitions pursuant to written commitments to purchase tax-exempt obligations.

   c. Note that in certain instances status as an obligation eligible for the 20-percent disallowance rule can be lost, and replaced by status as a obligation subject to the 100 percent disallowance rule. Rev. Rul. 90-44, 1990-1 C.B. 54.

   d. <u>See</u> Example #8, <u>infra</u>.

VII. <u>Foreclosure on Property Securing Loans</u>

A. Ordinarily, foreclosure on a loan is a taxable event: foreclosure constitutes the closing of the loan transaction and the beginning of a new investment in the acquired property.

B. The taxable event has two components (<u>see</u> Treas. Reg. § 1.166-6).

1. First, a bad debt is sustained, equal to the amount of the debt less the foreclosure sale (bid) price. An accrual basis bank that has reported accrued unpaid interest adds that accrued interest to the amount of the debt.

2. Second, a gain or loss is realized, equal to the amount of the mortgage debt applied to the bid price less the fair market value of the property acquired. Again, the amount of the debt may include accrued interest.

3. Depending on the bid price and the fair market value of the property, the tax consequences of this second component will vary. <u>Community Bank v. Comm’r</u>, 819 F.2d 940 (9th Cir. 1987).

4. <u>See</u> Example #9.

C. Formerly, section 595 provided a special rule applicable to thrift institutions.

1. Section 595 provided that for thrifts foreclosure is not a taxable event. Rather, the mortgage loan investment is carried forward in the property investment.

2. Thus, upon foreclosure, no bad debt deduction is allowed, and no gain or loss is recognized. Section 595(a). This rule was mandatory, not elective.

3. The acquired property has the same character as the debt. Thereafter, the thrift is treated as if it still had the debt. Section 595(b). The thrift's basis in the indebtedness is carried over as the basis of the property. Section-595(c).

4. <u>See</u> <u>Gibraltar Financial Corp. of California v. U.S</u>., 825 F.2d 1568 (Fed.-Cir. 1987) (the treatment of due & unpaid interest by a cash-basis thrift).

5. Section 595 was repealed by the 1996 Small Business Act for property acquired in years beginning after 1995.

VIII. <u>Combined Thrift-Life Insurance Business</u>

A. Mutual savings banks that operate a life insurance business in a department separate from their banking business pay a combined tax composed of two partial taxes. Section 594.

B. The first partial tax is computed by reference to only the banking part of the thrift.

C. The second partial tax is computed under Subchapter L by reference to the life insurance department.

IX. <u>Taxation of Depositors</u>

A. Interest paid on deposits is taxable. Section 61(a).

B. Dividends paid with respect to stock are taxable. Sections 61(a), 593(e).

C. <u>Losses on deposits in insolvent institutions</u>

1. In general, losses on deposits, incurred when a bank becomes insolvent, are treated as bad debts under section 166.

2. For an individual, except for deposits made in a trade or business, such bad debt losses are treated as short term capital losses. Section 166(d). Deduction of such losses is limited by section 1211 to the extent of $3,000 plus capital gains for the year.

3. For years after 1981, certain losses sustained by certain depositors are allowable as ordinary casualty losses under section 165(c). Section 165(1).

a. The depositor must not own 1 percent or more of the institution's stock, be an officer of the institution, or a relative thereof.

b. The deposit must be in a bank or a thrift (or certain other institutions).

X. Section 597

A. Under the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA), federal financial assistance (FFA) can be extended to financially troubled banks and thrift institutions.

1. Without any changes to the tax law, a bank receiving FFA from the federal government was not required to include such assistance in income or to make a downward basis adjustment to its assets.

2. Thus, a taxpayer might receive duplicative tax benefits due to the provision of tax-free financial assistance with no limitation on the deductibility of losses.

B. To prevent such duplicative tax benefits, FIRREA added Code section 597.

1. Section 597 provides the Treasury Department with authority to promulgate regulations on the tax treatment of FFA as long as the regulations do not allow the utilization of "any deduction (or other tax benefit) if such amount was in effect, reimbursed by nontaxable FFA."

2. The regulations provide that all FFA is ordinary income.

a. There are limits on how much FFA must be currently included in income.

b. The FFA income generally can be offset by built-in losses.

C. The regulations also provide that the acquisition of 50% or more of the stock of a troubled financial institution that has received FFA or has been under the control of certain government agencies, including the FDIC, will be treated as a deemed asset sale.

1. The effect of the deemed asset sale generally is to require the acquirer to take a cost basis in the acquired assets, eliminating losses inherent in those assets.

D. 2007-2008 Recession Developments

1. The FDIC has a program to provide financial assistance to financial institutions acquiring distressed banks.

a. Taxpayers were lobbying the IRS and Congress to provide that section 597 does not apply to such financial assistance.

2. The Treasury Department issued Notice 2008-101, which provides that "no amount furnished by the Department of the Treasury to a financial institution pursuant to the TARP established by the Secretary under EESA will be treated as the provision of Federal financial assistance within the meaning of section 597 of the Code and the regulations thereunder."

XI. <u>Taxation Of Common Trust Funds</u>

A. "Common trust funds" are pooled funds maintained by a bank in its capacity as trustee, executor, etc. Section 584(a).

B. A common trust fund is not a taxable entity. Section 584(b). It is treated as pass-through entity, similar to a partnership. Trust fund income is computed only for purposes of determining participants' income. Section 584(d).

C. <u>Taxation of participants</u>

1. Each participant includes in their income a proportionate share of the trust fund's income or losses, whether or not distributed. Section 584(c).

a. The IRS will challenge allocations of gain and loss where a common trust fund invests in offsetting positions in foreign currencies, and the investors in the trust fund include tax indifferent parties. Such a "common trust fund straddle tax shelter" is designated as a listed transaction for purposes of the disclosure, registration, and list maintenance requirements of sections 6011, 6111, and 6112. Notice 2003-54, 2003-33 I.R.B. 363.

2. Long term capital gains, short term capital gains, and ordinary gains and losses are treated separately.

3. Each participant is entitled to a proportionate share of tax-exempt income, etc.

4. Withdrawals from common trust funds

a. Upon entry into a fund, the participant purchases unit shares in the fund. The value of those units may fluctuate.

b. Upon withdrawal from the fund, the participant "sells" the units, realizing gain or loss equal to the amount received less the adjusted basis of the shares. Treas. Reg. § 1.584-4(a).

c. The value of the units at the time of withdrawal may reflect undistributed income, already taxed to the participant. To correct for this, the basis of the units is increased by the participant's share of undistributed income. Treas. Reg. § 1.584-4(b).

5. In years after 1995, a common trust fund may transfer substantially all of its assets to a RIC (or RICs) in exchange for RIC stock, and then transfer the RIC stock to its participants in exchange for their interests in the fund, without gain being recognized by either the fund or its participants. Section 584(h).

TAXATION OF REGULATED INVESTMENT COMPANIES (RICs)

I. General Considerations

A. Economic functions

1. Pooling of investments

2. Investment diversity

3. Provision of investment advice and management

B. General operation

1. These entities are intended to be vehicles for holding passive investments.

2. It is intended that the entities pass-through most of their income to shareholders.

3. If requirements designed to achieve these goals are satisfied, then the entity qualifies for special tax treatment that eliminates the burden of double taxation.

II. Taxation of Regulated Investment Companies

A. Qualification as a RIC

1. Eligible entities

a. Section 851(a) defines the types of domestic corporations that can elect to be taxed as a RIC. See Treas. Reg. § 1.851-1.

b. A RIC must be a corporation either (1) registered with the SEC under the Investment Company Act of 1940 as a management company or as a unit investment trust, or (2) that has elected to be treated as a business development company. Section 851(a)(1).

c. Also, a RIC may be a common trust fund that is not within the definition of section 584(a). Section 851(a)(2).

d. The 1984 Act removed the prohibition against personal holding companies (PHCS) qualifying for RIC status. See Rev. Rul. 88-41, 1988-1 C.B. 253.

e. Each series fund established by a RIC will be treated as a separate corporation and must separately meet all of the RIC qualification requirements. Section 851(g).

f. A RIC may have more than one class of shares, but no class may receive preferential dividend distributions. Rev. Rul. 89-81, 1989-1 C.B. 226.

g. A segregated asset account set up by a life insurance company to hold assets under investment contracts sold only as part of certain umbrella contracts providing for payment of annuities is not taxed separately from the insurance company and cannot elect RIC status. A similar account holding assets under certain investment contracts not sold in tandem with annuity contracts may be classified as a separate entity and may elect to be taxed as a RIC. Rev. Rul. 78-204, 1978-1 C.B. 216 , amplifying Rev. Rul. 70-525, 1970-2 C.B. 144.

2. Election of RIC status

a. An eligible corporation must elect to be taxed as a RIC. Section 851(b)(1).

b. To be able to make the election, the corporation must have been taxed as a RIC for all tax years ending on or after November 8, 1983 (Section 852(a)(2)(A)), or have no earnings and profits from any year in which it was not taxed as a RIC (Section 852(a)(2)(B)).

(1) A corporation can make distributions out of accumulated earnings and profits in order to comply with section 852(a)(2)(B). Section 852(c)(3).

(2) If an entity loses its RIC status, it can distribute non-RIC earnings and profits in order to requalify. Section 852(e).

3. Source of income requirement

a. At least 90 percent of the corporation's gross income must be from dividends, interest, payments with respect to securities loans, gains from the sale of stock or securities, or foreign currencies, or other income.[1] Section 851(b)(2).

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[1] For tax years prior to 1998, there were two income requirements, both of which were intended to ensure that the RIC primarily receives passive investment income. For years after 1997, only one requirement applies (the 90 percent test).

For pre-1998 years, it also was required that less than 30 percent of the corporation's gross income must be from the sale of certain types of investments held for less than three months, including stock or securities, options, futures, forward contracts, and foreign currencies not directly related to the RIC's principal investing business. Pre-1997 Act section 851(b)(3).

(1) The 1986 Act expanded the allowable categories of gross income to include certain foreign currency gains.

(2) The Treasury is authorized to issue regulations excluding foreign currency gains not directly related to the RIC's principal investing business.

(3) Income from a partnership or trust is includible only if it would be includible had the RIC received the income directly.

(4) Reimbursements received from the RIC's investment advisor may constitute qualifying income. Rev. Rul. 92-56, 1992-2 C.B. 153. Reimbursements from a subsidiary for expenses are not income under Code Sec. 61(a) and are not subject to the gross income requirement of Section 851(b)(2). Rev. Rul. 84-138, 1984-2 CB 123.

(5) For tax years beginning after October 22, 2004, qualifying income also includes income and gains from qualified publicly traded partnerships ("qualified PTPs"). Section 851(b)(2)(B), as amended by section 331 of the American Jobs Creation Act of 2004, Pub. L. No. 108-357 ("2004 Jobs Act").

(a) A "PTP" is any partnership if (1) interests in such partnership are traded on an established securities market, or (2) interests in such partnership are readily tradable on a secondary market (or the substantial equivalent thereof).

(b) A "qualified PTP" includes a PTP as defined in section 7704(b), other than a partnership that derives 90% or more of its income from interest, dividends, capital gains, and other sources of traditional qualifying RIC sources of income. Section 851(h). Note that a qualified PTP may invest in any type of business, e.g., oil and gas.

Pre-1997 Act section 851 (g) (enacted in the 1986 Act) provided a special rule applicable when a RIC hedges its investments and special rules for abnormal redemptions by funds that belong to a series fund.

In 1997, the 30 percent test was repealed by the Taxpayer Relief Act of 1997 for tax years beginning after August 5, 1997. See P.L. 105-34, section 1271.

(6) The IRS will not challenge a PTP's determination that COD income is qualifying under Code Sec. 7704(d) if the COD income is attributable to debt incurred in direct connection with activities of PTP that generate qualifying income. Rev. Proc. 2012-28.

(7) Income and gains from commodity-index derivatives contract investments is not qualifying income under section 851(b)(2). Derivatives contracts providing for total return exposure on commodity index are not themselves securities. Rev. Rul. 2006-1, modified and clarified by Rev. Rul. 2006-31.

b. For purposes of the 90-percent test:

(1) capital losses are ignored, and

(2) tax-exempt interest is included in income.

c. See Example #10, infra.

d. The Regulated Investment Company Modernization Act of 2010 (P.L. 111-325)[2] provides an exception for failure to satisfy the source income test.

(1) A corporation that fails to meet the source income test for any taxable year is considered to satisfy to satisfy the requirement if:

(a) Following the RIC's identification of the failure, a description of each item of its gross income that satisfies the source income test is provided to the Secretary, and

(b) Failure to meet such requirement is due to reasonable cause and not due to willful neglect. Section 851(i)(1)

(2) In addition, there is a tax in an amount equal to the excess of (A) the gross income of such company which is not derived from sources satisfying the source income test over (B) 1/9 of the gross income of such company which is derived from such sources. Section 851(i)(2).

[2] The provision enacted by the Regulated Investment Company Modernization Act of 2010 is generally effective for tax years beginning after 12-22-2010.

4. Investment diversification requirements

   a. There are two investment requirements, both of which must be met at the close of each quarter.

   b. First, at least 50 percent of the corporation's assets must be invested in cash, government securities, RIC securities, and certain other types of securities. Section 851(b)(3)(A).

      (1) "Government securities" include Treasury securities, as well as Federal National Mortgage Association (FNMA), Government National Mortgage Association (GNMA), Student Loan Marketing Association (SLMA), Federal Home Loan Bank (FHLB) and Federal Home Loan Mortgage Corporation (FHLMC) obligations, as well as certain investments in refunded bonds. Rev. Rul. 2003-84, 2003-32 I.R.B. 289; Rev. Rul. 92-89, 1992-2 C.B. 154; GCM 39626 (Apr. 29,1987); LTR 8806044 (Nov. 17, 1987); LTR 9006015 (Nov. 8, 1989); LTR 9015011 (Jan. 8, 1990). A RIC's investment in a "repo" transaction involving a government security qualifies as an investment in the government security itself, as long as the repo is "fully collateralized" as defined by Securities and Exchange Commission Rule 5b-3 (effective for repos held by a RIC as investments on or after August 15, 2001). Rev. Proc. 2004-28, 2004-22 I.R.B. 984.

      (2) The RIC can be treated as directly owning the assets held by certain partnerships. Rev. Proc. 2005-20.

      (3) For purposes of the 50-percent test, a RIC may not count securities of any (non-RIC, non-government) issuer if:

         (a) the value of those securities exceeds 5 percent of the value of the RIC's assets, or

         (b) the securities exceed 10 percent of the issuer's outstanding voting securities (including equity securities of a qualified PTP for tax years beginning after October 22, 2004). Section 851(b)(3)(A); section 851(c)(5).

      (4) If the 50-percent test is met, the RIC's other investments need not be diversified.

      (5) <u>See</u> Example #11, <u>infra</u>.

(6) There is an exception to the 50-percent test applicable to certain RICs that are certified by the SEC as principally engaged in furnishing venture capital to corporations engaged in inventing or developing new products or processes, etc. Section 851(e).

(a) In the 50-percent test, the RIC may include stock even if it holds more than 10 percent of the stock of the issuer. (However, this exception does not apply if the RIC has held the stock for 10 or more years.)

(b) In the 50-percent test, the 5-percent limit also is modified. A RIC may hold stock the cost (rather than value) of which is 5 percent of the value of the RIC's assets as of the date of the last acquisition of the stock of that issuer.

(c) See Example #12, infra.

c. Second, no more than 25 percent of the value of the RIC's total assets may be invested in securities (other than government or other RIC securities) of one issuer, or of two or more issuers (1) of which the RIC owns 20 percent or more, and (2) which are in similar or related businesses. Section 851(b)(3)(B). For tax years beginning after October 22, 2004, this includes securities of qualified PTPs. Section 851(b)(3)(B).

(1) This test counts both stock held directly by the RIC, and the proper proportion of stock held by corporations at least 20-percent owned by the RIC. Section 851(c).

(2) See Example #13, infra.

d. The two investment diversification tests must be satisfied quarterly. If a RIC satisfies the tests for one quarter, and then, due solely to fluctuations in market value, fails to meet one of the tests in the next quarter, it retains RIC status. Section 851(d)(1).

e. The Regulated Investment Company Modernization Act of 2010 (P.L. 111-325) provides special rules regarding failure to satisfy the two investment diversification tests provided the exception in section 851(d)(1) does not apply.

(1) Reasonable Cause: A RIC that fails to meet the investment diversification tests is considered to satisfy the tests for such quarter if (i) a description of the asset causing the failure is filed in the manner provided by the Secretary, (ii) the failure is due to reasonable cause and not due to willful

neglect, and (iii) the RIC disposes of the assets causing the failure or the requirements are otherwise met within 6 months after the last day of the quarter in which the RIC identified the failure. Section 851(d)(2)(A).

(a) If the reasonable cause exception applies for any quarter, a tax is imposed on the RIC equal to the greater of (I) $50,000, or (II) the amount determined by multiplying the net income generated by the assets causing the RIC to fail the investment diversification test for the relevant period times the highest rate of tax in Section 11. Section 851(d)(2)(C)(i).

(b) The relevant period is the period beginning on the first date that the failure to satisfy the investment diversification test occurs as a result of the ownership of such assets and ending on the earlier of the date on which the corporation disposes of such assets or the end of the first quarter when there is no longer a failure to satisfy the investment diversification requirements. Section 851(d)(2)(C)(ii).

(2) De Minimis: A RIC that fails to meet the investment diversification tests is considered to satisfy the tests for such quarter if (i) such failure is due to the ownership of assets the total value of which does not exceed the lesser of (I) 1% of the total value of the corporation's assets at the end of the quarter, or (II) $10,000,000, and (ii) the RIC disposes of the assets causing the failure or the requirements are otherwise met within 6 months after the last day of the quarter in which the RIC identified the failure. Section 851(d)(2)(B).

f. RIC status will not be lost if a distribution to shareholders causes it to fail one of the tests. Treas. Reg. § 1.851-5, Example (5).

g. However, if a RIC fails one of the tests due to the acquisition of new assets, then RIC status will be lost, unless assets are disposed of and the tests are satisfied within 30 days of the close of the quarter in which the tests are failed. Section 851(d)(1).

h. In response to the financial systems affecting the banking system and the financial markets in 2009, the government established the Troubled Asset Relief Program (TARP). One of the TARP programs partners the government with private investors to form

Public-Private Investment Partnerships ("PPIP"). For purposes of the two investment requirements (section 851(b)(3)), the RIC will be treated as if it directly invested in assets held by the PPIP in which it invests provided that (1) the RIC invests, as a partner, at least 70% of its original assets in one or more PPIPs, and (2) the PPIP is treated as a partnership for federal tax purposes. For these purposes, the RIC's interest in PPIP assets is determined in accordance with its percentage of ownership of the capital interests in the PPIP. Rev. Proc. 2009-42.

5. A RIC holding an interest in a partnership other than a qualified PTP is deemed to hold a proportionate part of the partnership's assets, and to receive a proportionate part of the partnership's income for purposes of the asset and income qualification requirements. LTR 9332031 (May 17, 1993).

6. Distribution requirements

   a. For each year, the RIC must distribute an aggregate amount, ignoring capital gains, that equals or exceeds the sum of (section 852(a)(1)):

      (1) 90 percent of its gross "investment company taxable income," plus

      (2) 90 percent of the excess of its tax-exempt interest income over expenses allocable thereto.

   b. The amounts distributed must qualify under the section 243 DRD provisions. The distribution may not qualify for the DRD if it is a preferential dividend. Rev. Rul. 89-81, 19891 C.B. 226.

   c. These distribution requirements may be waived if the RIC is unable to comply due to prior distributions made to avoid imposition of the section 4982 excise tax.

   d. In order to meet these requirements, a RIC may elect to treat certain dividends paid after the close of a taxable year as paid during the taxable year.

      (1) Section 852(b)(7) provides that dividends declared and payable to shareholders of record on a date during the last three months of a calendar year (and actually paid during January of the following calendar year) are deemed paid on December 31 of that calendar year.

      (2) Section 855(a) provides that if a RIC declares a dividend and distributes the dividend within 12 months of year end

(but not later than its first regular dividend payment), the RIC may elect in the return to treat the dividend as paid for the year covered by the return. For distributions in tax years beginning on or before 12-22-2010, the RIC must declare the dividend before its return due date. The Regulated Investment Company Modernization Act of 2010 (P.L. 111-325) revised the rule to provide that for distributions in tax years beginning after 12-22-2010, the RIC must declare a dividend before the later of (A) the 15th day of the 9th month following the close of the taxable year, or (B) in the case of an extension of time for filing the company's return for the taxable year, the due date for filing such return taking into account such extension.

(3) Section 860 allows for the deduction of deficiency dividends. The 2004 Jobs Act expanded the definition of a deficiency dividend to include additional amounts required to be paid, as determined by the RIC prior to any controversy with the IRS. New section 860(e)(4).

B. <u>Taxation of RICs</u>

1. If a corporation fails to qualify as a RIC, it will be taxed as an ordinary corporation on its entire taxable income (although it can claim the 70-percent section 243 deduction). Distributions of earnings will be taxable as dividends to the extent of current earnings and profits, and thereafter will be applied against shareholders' basis in their shares.

2. If the corporation qualifies as a RIC:

a. The RIC is taxed on its investment company taxable income ("ICTI"), which is its taxable income, less (i) net capital gain, (ii) amounts of ordinary, taxable income distributed to shareholders and eligible for the section 561 deduction for dividends paid, (iii) an amount equal to the tax imposed by section 851(d)(2) and (i), and (iv) certain other adjustments. Section 852(b)(1), (2) and (8).

(1) ICTI thus is comprised of retained, taxable, ordinary income.

(2) Tax on ICTI is imposed at section 11 rates. If a RIC is a personal holding company, the tax is computed at the highest section 11 rate.

(3) The deduction for dividends paid may not be allowed if the RIC favors a class of shareholders with preferential

dividend distribution treatment. Rev. Rul. 89-81, 1989-1 C.B. 226.

(4) The Regulated Investment Company Modernization Act of 2010 (P.L. 111-325) repeals the preferential dividend rules for publicly offered RICs for taxable years beginning after December 22, 2010. Section 562(c).

(5) Income or gains from a RIC's interest in a qualified PTP is subject to the passive activity rules of section 469(k)(4). Thus, a RIC can recognize losses from a qualified PTP only to the extent of income or gains from that PTP.

b. The RIC is also taxed on its undistributed net capital gain, (i.e., capital gains less capital gain dividends). Section 852(b)(3). Certain losses incurred after October 31st of the year may be excluded in computing net capital gain for the year. Treas. Reg. § 1.852-11.

c. The RIC is not taxed on its tax-exempt interest. However, in computing ICTI, a prorated amount of expenses are not deductible by RICs that distribute tax-exempt dividends. Section 265(a)(3).

d. The RIC also is subject to an excise tax on undistributed income.

(1) The amount of the excise tax is 4 percent of the excess of (i) 98 percent of ordinary income for the calendar year, plus 98.2 percent of net capital gain for the year ending October 31, over (ii) the amount distributed. This amount will be increased by amounts not distributed in the preceding year. Section 4982. The Regulated Investment Company Modernization Act of 2010 (P.L. 111-325) increased the percent of net capital gain from 98 percent to 98.2 percent effective for calendar years beginning after 12-22-2010.

(2) The RIC is excepted from the excise tax if it is owned by certain types of taxpayers, including qualified pension trusts. Section 4982(f).

C. Taxation of RIC Shareholders

1. Ordinary Income Dividends

a. RIC dividends of ordinary income are includible in gross income, to the extent of the RIC's earnings and profits. Treas. Reg. § 1.852-4(a)(1). See section 854(b).

(1) Special rules for determining RIC earnings and profits are provided. Section 852(c).

(2) If the RIC has no E&P, the dividends are a non-taxable return of capital, which reduces the basis of the shareholder's shares.

(3) Section 1(h)(11) provides that "qualified dividend income" is taxed as capital gain instead of ordinary income. Dividends distributed by RICs are "qualified dividend income," but are subject to the limitations of section 854(b).

2. The section 67 rules regarding the two percent floor on miscellaneous itemized deductions are not taken into account at the pass-through entity level, but at the owner level.

a. However, the two percent floor does not apply to any publicly offered RIC. Section 67(c)(2).

b. For non-publicly traded RICs, dividends may be grossed-up to reflect the shareholder's share of investment expenses.

3. Tax-exempt interest dividends

a. RICs that invest at least 50 percent of the value of their total assets in tax-exempt obligations may distribute tax-exempt dividends. Section 852(b)(5).

(1) For purposes of this asset test, RICs that hold partnership interests described in Rev. Proc. 2002-68, 2002-43 I.R.B. 753, called "synthetic tax-exempt variable-rate bonds," are treated as if they directly invested in the assets held by the partnership. Rev. Proc. 2005-20, 2005-1 CB 990, amplifying and superseding Rev. Proc. 2003-32, 2003-1 C.B. 803.

b. The amount of the tax-exempt dividend equals tax-exempt interest income less expenses allocable thereto.

c. Tax-exempt dividends must be so designated by written notice to shareholders.

d. The Regulated Investment Company Modernization Act of 2010 (P.L. 111-325) adds new rules permitting the pass-through of tax-exempt dividends to qualified fund of funds. A qualified fund of funds means a RIC at least 50 percent of the value of its total assets is represented by interests in other RICs. Section 852(g).

4. Foreign tax credit

   a. Ordinarily, a RIC is entitled to the same credit or deduction for foreign taxes as any other corporation.

   b. Under certain conditions, the RIC can transfer that right to its shareholders, and, in effect, the shareholders are treated as directly owning stock in a foreign corporation. Treas. Reg. 1.853-2(b).

   c. If the company transfers the right, it loses the deduction or credit, but adds the amount of taxes involved in the right so transferred to its dividends paid deduction. Each shareholder of the electing RIC includes in gross income and treats as paid, his or her share of foreign taxes. Section 853(a), (b).

   d. The Regulated Investment Company Modernization Act of 2010 (P.L. 111-325) adds new rules permitting the pass-through of foreign tax credits to qualified fund of funds. A qualified fund of funds means a RIC at least 50 percent of the value of its total assets is represented by interests in other RICs. Section 852(g).

5. Capital gain dividends

   a. RIC dividends of capital gain are taxable to shareholders as long-term capital gain, regardless of the shareholder's holding period. Section 852(b)(3).

   b. Capital gain dividends must be so designated by written notice to shareholders.

   c. Shareholders are taxed on the capital gain dividends at the capital gains rates of section 1(h).

   d. For purposes of computing the maximum tax rate on dividends taxed as capital gain under section 1(h)(11), capital gain dividends distributed by RICs are not treated as dividends. Section 854(a).

   e. RIC capital gain dividends used to increase net investment income under Section 163(d)(1)(B) and corresponding allowable investment interest deduction are taxable as ordinary income. Kocurek v. U.S., 628 F2d 906 (5th Cir. 1980).

6. Undistributed capital gains

   a. Undistributed capital gain also can be reported as taxable to shareholders, as long-term capital gain. Section 852(b)(3)(D).

b. The RIC pays a tax on undistributed capital gain. Section 852(b)(3)(A). Shareholders are deemed to have paid that tax. Section 852(b)(3)(D)(ii).

c. The shareholder's basis in his RIC shares is increased by the difference between the amount of undistributed capital gain and the tax deemed paid by the shareholder in respect of such shares. Section 852(b)(3)(D)(iii).[3]

7. Year in which dividends are taxable

a. Generally, amounts paid to RIC shareholders are taxable to the shareholders in the year received. See also section 855(b).

b. If a RIC declares a dividend under the section 852(b)(7) procedure, the dividend will be deemed received on December 31 of the calendar year in which it is declared.

8. Special Rules Applicable to Non-U.S. Investors

a. The 2004 Jobs Act provides an exemption from U.S. basis tax for certain "interest-related dividends" and "short-term capital gain dividends" paid by a RIC to a non-U.S. person. Sections 871(k)(1)-(2); 881(e)(1)(A)(effective for tax years beginning after December 31, 2004).

b. The 2004 Jobs Act extends current law treatment of gain from the exchange of U.S. real property interests by REITs to RICs. Thus, any distribution by a qualified RIC to a foreign person will, to the extent attributable to gain from the sale or exchange of a U.S. real property interest, be treated as gain recognized from the sale or exchange of a U.S. real property interest. Section 897(h)(1).

9. Sales of RIC shares

a. In general, sales of RIC shares are treated like sales of other capital assets.

b. However, if RIC shares are held for 6 months or less, and then sold at a loss, then the loss (section 852(b)(4)):

[3] For tax years beginning on or before August 5, 1997, a shareholder's basis is increased by 65 percent of the undistributed capital gain. Pre-1997 Act section 852(b)(3)(D)(iii).

(1) to the extent that the shareholder has received a capital gain dividend, or has been credited with undistributed capital gain, shall be a long term capital loss.

(2) to the extent that the shareholder has received a tax-exempt interest, shall be disallowed.

TAXATION OF REAL ESTATE INVESTMENT TRUSTS (REITs)

I. General Considerations

A. Economic functions

1. Pooling of investments

2. Investment diversity

3. Provision of investment advice and management

B. General operation

1. These entities are intended to be vehicles for holding passive investments.

2. It is intended that the entities pass-through most of their income to shareholders.

3. If requirements designed to achieve these goals are satisfied, then the entity qualifies for special tax treatment that eliminates the burden of double taxation.

III. Taxation of Real Estate Investment Trusts

A. Qualification as a REIT

1. Eligible entities

Section 856(a) lists numerous organizational requirements. To be eligible, an entity must be:

a. a corporation, trust, or association,

b. otherwise taxable as a domestic corporation (See Rev. Rul. 89-130, 1989-2 C.B. 117),

c. managed by one or more trustees or directors,

d. issuing transferable shares or certificates (See Rev. Rul. 69-610, 1969-2 CB 149 (two classes of shares are permitted),

e. which are held by 100 or more persons (no attribution rules apply)(Section 856(h)), and

f. 50 percent of which are not owned, directly or indirectly, by 5 or fewer individuals (attribution rules apply). REIT stock held by

Section 501(c)(3) tax-exempt organization and by charitable trust was not treated as stock held by individual under Code Sec. 542(a)(6). LTRs 200403027 and 200507004.

(1) For purposes of this 5-or-fewer rule, a pension trust is not treated as a single shareholder. Rather, the beneficiaries of the pension trust are counted in determining the number of REIT shareholders. Section 856(h)(3).

(2) For tax years beginning after August 5, 1997, an entity that complies with Treasury regulations that require the REIT to maintain records that allow the IRS to ascertain actual ownership of its shares, and does not know whether it meets this test, is treated as having met the ownership rule. Section 856(k). No regulations have been issued yet.

g. Section 856(h)(2) waives the last two requirements (e and f) for the REIT's first year.

h. Recordkeeping Requirements

(1) The REIT must keep records that allow the IRS to ascertain its actual ownership.

(2) Former Rule - If the entity failed to keep records, the entity was disqualified from REIT status. Former section 857(a)(2).

(3) New Rules -

(a) If the entity fails to keep records, the REIT pays a $25,000 penalty for each tax year in which the failure occurs. Section 857(f)(2).

(b) As described above, section 856(k) provides relief if a REIT complies with the recordkeeping rules.

2. Election of REIT status

a. An eligible entity must elect to be taxed as a REIT. Section 856(c)(1).

b. To be able to make the election, the entity must have been taxed as a REIT for all tax years beginning after February 28, 1986, or have no earnings and profits from any year in which it was not taxed as a REIT. Section 857(a)(2). See also section 859, which requires a REIT to use the calendar year as its accounting period.

c. If an election is terminated due to failure to qualify as a REIT, or is revoked, REIT status generally may not be reelected for five years. Section 856(g)(3). The 2004 Jobs Act allows an entity that has failed to qualify as a REIT (for reasons other than a failure of the 95-percent and 75-percent income tests, and other than the rules for failures of the asset tests) to pay a $50,000 penalty for each failure and retain its REIT status, as long as the failure is due to reasonable cause and not willful neglect. New section 856(g)(5).

3. Income requirements

a. There are two income requirements, both of which must be met annually, and which are intended to ensure that the REIT receives primarily passive real estate income.[4]

b. First, at least 75 percent of the REIT's gross income must be derived from "rents" from real property, "interest" from loans secured by real property or interests in real property, gain from the sale of investment real property, REIT dividends, income from "foreclosure property," "qualified temporary investment income," and other specified sources. Section 856(c)(3).

(1) "Rents from real property" includes traditional rent, as well as certain charges for services customarily furnished in connection with the rental of real property. Section 856(d)(1)(A)-(B). See also, Rev. Rul. 2004-24, 2004-10 I.R.B. 550 (amounts paid for parking facilities); LTR 9013043 (Dec. 28, 1989).

(2) "Rents from real property" also includes rent from personal property which is leased in connection with the lease of real property, if the rent from the personal property does not exceed 15% of the total rent for the combined lease. Section 856(d)(1)(C).

(3) The definition of "rents" excludes amounts determined by reference to the net income or profits of the lessee or other third party. Section 856(d)(2)(A).

(a) Rent includes amounts based on fixed percentages of gross receipts or sales.

(b) There is a limitation on this exclusion rule. If a lessee subleases the property and receives contingent rents, only a portion of those rents are

[4] A third "less than 30%" requirement was repealed by the 1997 Act for years after 1997.

excluded from the rental income of the REIT. Section 856(d)(4).

(c) An exception to the exclusion rule applies if a lessee derives substantially all of its income with respect to the leased property from subleasing the property, and a portion of the lessee's income consists of "qualified rents," i.e., payments that would constitute rents from real property if received directly by the REIT. Under the exception, such qualified rents are not excluded from the rental income of the REIT. Section 856(d)(6).

(4) The definition of "rents" excludes amounts received from certain related entities. Thus, if a REIT owns 10% or more (by vote or value, assets, or net profits) of an entity, and directly or indirectly receives amounts from that entity, those amounts are excluded from the rental income of the REIT. Section 856(d)(2)(B).

(a) An exception to this rule is provided for amounts received from a "taxable REIT subsidiary." The exception applies if either:

i) At least 90% of the leased space is rented to individuals or entities other than taxable REIT subsidiaries or entities that are less than 10% owned by the REIT, and the rental paid by all renters is "comparable." Section 856(d)(8)(A).

a) Comparable rents are to be tested at the time the lease is entered into, any time the lease is extended, and any time the lease between the REIT and the taxable REIT subsidiary is modified to increase the rental.

b) Increases in rent paid by a "controlled REIT subsidiary" (defined as a REIT where more than 50% of the voting power or more than 50% of the value is owned by the REIT whose qualifying income is being determined) are not taken into account.

ii) The property leased to the taxable REIT subsidiary is a "qualified lodging facility" as defined in section 856(d)(9)(D) that is operated on behalf of the taxable REIT subsidiary by an eligible independent contractor, as defined in section 856(d)(3) and (d)(9)(A). Section 856(d)(8)(B).

(5) The definition of "rents" excludes impermissible tenant service income, which is defined in section 856(d)(7) to include income from services furnished to tenants by the REIT, and income for management or operation of the property by the REIT.

If services, including management or operation services, are furnished through an independent contractor from whom the REIT does not receive any income, or through a taxable REIT subsidiary, the tenant service income is not excludible from the rental income of the RETT. Section 856(d)(7)(C)(i). See also, Rev. Rul. 2003-86, 2003-2 I.R.B. 290 (services provided by joint venture between taxable REIT subsidiary and third party corporation do not disqualify rents paid to REIT). See also Rev. Rul. 2007-33, 2007-21 IRB 1281; Rev. Rul. 2004-24, 2004-1 CB 550; Rev. Rul. 2002-38, 2002-2 CB 4.

(a) A 1% de minimis exception to the exclusion rule applies. Section 856(d)(7)(B). See Rev. Rul. 98-60, 1998-2 CB 751.

(b) An exception also applies to income that would not otherwise qualify as unrelated business taxable income ("UBIT"). Section 856(d)(C)(ii).

(c) The purpose of these rules is to ensure that the RETT does not carry on an active service business. LTR 9014022 (Jan. 2, 1990).

(6) "Interest" excludes certain amounts determined by reference the net income or profits of the lessee or other third party. Section 856(f).

The purpose is to ensure that the REIT is not a joint venturer with the lessee.

(7) "Foreclosure property" is property acquired in foreclosure or on threat thereof. In order for property to be treated as foreclosure property, the REIT must make an election prior to the due date for filing the return for the tax year in which the property is acquired. Such property ceases to qualify as foreclosure property after the REIT has held it for 3 years (2 years for qualified health care facilities), or up to 6 years, if extended. Section 856(e)(2)-(3) and (e)(6).

(8) "Qualified temporary investment income" is income from certain stock or debt attributable to investment of new capital during the 1-year period following receipt of the capital. Section 856(c)(5)(D).

c. Second, at least 95 percent of the REIT's gross income must be from the sources specified in the 75-percent test, plus income from interest, dividends, and gains from the sale of stock or securities. Section 856(c)(2). Certain hedging transactions also qualify. Section 856(c)(5)(G) (amended by 2004 Jobs Act and the Housing Assistance Tax Act of 2008).

d. Failure to satisfy the 75 percent and 95 percent tests will not cause loss of REIT status if such failure was due to reasonable cause and if all income is listed on a schedule to the return. Section 856(c)(6).

e. <u>See</u> Example #14, <u>infra</u>.

4. Investment diversification requirements

a. There are three investment requirements, all of which must be met at the close of each quarter. (The second requirement was added by the 1999 Act.)

b. First, at least 75 percent of the value of the REIT's total assets must consist of "real estate assets," cash and cash items, and government securities. Section 856(c)(4)(A). <u>See</u> Rev. Proc. 2012-14 and Rev. Proc. 2011-16.

(1) "Real estate assets" include fee ownership, leaseholds, options, mortgages, REIT shares, all or part of interests in REMICs, and "temporary investments of new capital." Section 856(c)(5)(B) and (C).

(a) Generally, loans secured by interests in partnerships and disregarded entities that own a substantial amount of real property may qualify as real estate assets. Rev. Proc. 2003-65, 2003-32 I.R.B. 336;

LTR 200225034 (Mar. 21, 2002); LTR 200225033 (Mar. 21, 2002); LTR 200226013 (Mar. 21, 2002).

(2) The term excludes mineral, oil, and gas interests. Section 856(c)(5)(C).

(3) Voting interests in property owners' associations that are inextricably linked to property ownership, constitute "real estate assets" and not "voting securities" LTR 9826049 (Apr. 1, 1998).

c. Second, not more than a certain percentage of the value of the REIT's assets can be securities of a "taxable REIT subsidiary."

(1) For tax years beginning on or before July 30, 2008, the applicable percentage is 20%.

(2) For tax years beginning after July 30, 2008, the applicable percentage is 25%

d. Third, (excluding government securities, securities that are real estate assets, and securities of taxable REIT subsidiaries) not more than 25 percent of the value of the REIT's total assets can consist of securities that are:

(1) an amount that is in value greater than 5 percent of the value of the REIT's assets,

(2) more than 10 percent of the voting power of the issuer.

(3) more than 10 percent of the value of the issuer's securities. Section 856(c)(4)(B).

(a) Section 856(m) provides a safe harbor for certain investments that will not be treated as "securities" for the third part of the third test. These investments include (1) "straight debt" as defined by section 1361(c)(5); (2) loans to an individual or an estate; (3) section 467 rental agreements; (4) an obligation to pay rents from real property; (5) certain state, municipal, and foreign securities; (6) REIT securities; and (7) any other arrangement designated by the Secretary of the Treasury as not constituting a security. Section 856(m)(1).

(b) Under the "straight debt" rule, certain contingencies related to the timing of payments of principal or interest will not disqualify an instrument -- it can still be excluded from the 10 percent test. Contingencies will not cause failure if

i) they do not change the annual yield to maturity under section 1272 by more than the greater of 1/4 of 1%, or 5 percent of annual yield, or

ii) neither the aggregate issue price nor the aggregate face amount of the issuer's debt instruments held by the REIT exceeds $1 million and not more than 12 months of unaccrued interest can be required to be prepaid under the instrument, or

iii) the time or amount of payment is subject to a contingency upon default or the exercise of a prepayment right by the issuer, but only if such contingency is "consistent with customary commercial practice."

(c) If a REIT owns securities described in section 856(m)(1) of an issuer that is a corporation or a partnership, such securities will not be excluded from the 10-percent test if: (1) the REIT or any of its controlled taxable REIT subsidiaries holds any securities of that issuer not described in section 856(m)(1); and (2) have an aggregate value of greater than 1 % of that issuer's outstanding securities. Section 856(m)(2)(C).

(d) The provision provides also that, for purposes of the 10 percent test, if a REIT owns an interest in a partnership, the REIT will be treated as owning its proportionate share of the assets of the partnership (the "partnership look-through rule"). Section 856(m)(3).

e. If a REIT fails to satisfy these asset requirements for a quarter, REIT status will not be lost. Section 856(c)(7).

(1) If the failure is other than for failing to meet 856(c)(4)(B)(iii), REIT status can be preserved by filing an informational schedule, proving reasonable cause, and disposing of the offending assets and satisfying the tests within 6 months of the close of the quarter. Section 857(c)(7)(A).

(a) In this case, a tax is imposed equal in amount to the greater of $50,000 or the income generated by the assets times the highest rate of tax specified in section 11.

(2) If the failure is for failing to meet section 856(c)(4)(B)(iii) for any quarter, it may cure the failure if it is caused by the REIT's ownership of assets the total value of which does not exceed the <u>lesser of</u> 1% of the total value of the REIT's assets at the end of the quarter for which the measurement was done, or $10 million. Once such failure is identified, the REIT must dispose of the offending assets within 6 months from the end of the quarter in which the failure was identified. Section 856(c)(7)(B).

(3) <u>See</u> Example #15, <u>infra</u>.

5. For purposes of the income and asset tests, the income and assets of a REIT and its wholly-owned "qualified REIT subsidiary" are aggregated. The subsidiary is not treated as a separate entity. Section 856(i). <u>See</u>, e.g., LTR 200236037 (May 10, 2002) (income from partnership interests owned by qualified REIT subsidiaries is included in gross income of REIT).

6. Distribution requirements

a. For each year, the REIT must distribute an amount, ignoring capital gains, that equals or exceeds (section 857(a)(1)(A)):

(1) 90 percent of "REIT taxable income," excluding net capital gain, plus

(2) 90 percent of net income from foreclosure property less the tax imposed thereon, minus

(3) any excess noncash income.

(4) For years prior to 2001, the foregoing percentage was 95% rather than 90%.

b. "Excess noncash income" is the excess of noncash income over 5 percent of ordinary REIT taxable income. Noncash income includes amounts of income, for example income from cancellation of indebtedness and OID, that are accrued but not received. Section 857(e).

c. These distribution requirements may be waived if the REIT is unable to comply due to prior distributions made to avoid imposition of the section 4982 excise tax. Section 857(a).

d. In order to meet these requirements, a REIT may elect to treat certain dividends paid after the close of a taxable year as paid during the taxable year.

(1) Section 857(b)(9) provides that dividends declared and payable during the last three months of a calendar year (and actually paid during January of the following calendar year) are deemed paid on December 31 of that calendar year (or, if earlier, as provided by section 858).

(2) Section 858(a) provides that if a REIT declares a dividend before its return due date, and distributes the dividend within 12 months of year end (but not later than its first regular dividend payment), the REIT may elect in the return to treat the dividend as paid for the year covered by the return.

(3) Section 860 allows for the deduction of deficiency dividends. The definition of a deficiency dividend includes additional amounts required to be paid, as determined by the REIT prior to any controversy with the IRS. Section 860(e)(4).

e. <u>See</u> Example #16, <u>infra</u>.

B. <u>Taxation of REITs</u>

1. REITs are potentially subject to tax on the following amounts:

a. undistributed REIT taxable income,

b. undistributed net capital gain,

c. income from foreclosure property,

d. the income “shortfall” in failing to meet the 75 or 95 percent tests,

e. income from prohibited transactions,

f. income from redetermined rents, etc.

2. Tax on undistributed REIT income

a. A tax is imposed on “REIT taxable income”:

(1) Taxable income (including undistributed capital gains, excludes foreclosure and prohibited transaction income)

(2) Less deduction for dividends paid (but not of foreclosure income)

(3) Less items c and e(listed in the preceding paragraph), the tax on items d and f (listed in the preceding paragraph), and the section 856(c)(7)(C) tax. Section 857(b)(2).

b. The tax is imposed at section 11 rates.

3. Tax on undistributed capital gains

a. An alternative tax is provided in the case of capital gains, net of distributed capital gains, similar to section 1201. Section 857(b)(3).

b. The REIT may elect to retain its net long term capital gains and pay tax on those gains. Section 357(b)(3)(D).

4. Tax on income from foreclosure property

a. A separate tax is imposed on the excess of ordinary income on the sale of (noninvestment) foreclosure property and income derived from the operation of foreclosure property, over deductions allowable in connection with production of such income. Section 857(b)(4).

b. "Conduit" treatment is not available for this type of income.

c. The tax is imposed at the highest section 11 rate.

5. Tax on income requirement "shortfalls"

a. As discussed above, an entity may qualify for REIT tax status even if it fails the 75 or 95 percent test.

b. However, a tax is imposed equal to the greater of the shortfall in failing to meet the 75 percent test, and the shortfall in failing to meet the 95 percent test. Section 857(b)(5).

6. Tax on Income from prohibited transactions

A tax is imposed equal to the net income derived in prohibited transactions. A "prohibited transaction" is the sale of property, other than foreclosure property, that is held primarily for sale under section 1221(a)(1). Section 857(b)(6).

Exceptions to characterization as a prohibited transaction apply if (1) the REIT has held the property for a specified number of years before selling it [4 years for sales made on or before July 30, 2008 and 2 years for sales made after July 30, 2008], and (2) other conditions are satisfied. Section 857(b)(6)(C).

7. Tax on Income From Redetermined Rents, etc.

a. A 100% tax is imposed on "redetermined rents," redetermined deductions," and "excess interest."

(1) "Redetermined rents" are defined as rents from real property to the extent that the rents "would be" reduced under section 482 to clearly reflect income as a result of services rendered by a taxable REIT subsidiary to a tenant of the REIT. Section 857(b)(7)(B). Exceptions to the definition of redetermined rents similar to the exceptions to the definition of impermissible tenant service income are available. See, e.g., Rev. Rul. 2002-38, 2002-26 I.R.B. 4 (addressing the applicability of the section 857(b)(7)(B)(vi) safe harbor to housekeeping services performed by a taxable REIT subsidiary).

(a) The 2004 Jobs Act repealed the section 857(b)(7)(B)(ii) customary services exception to redetermined rents for amounts received by a REIT from its taxable REIT subsidiary. However, a REIT can still avoid the 100% excise tax by paying its taxable REIT subsidiary at least 150 percent of the cost to the subsidiary of providing the services. See 2004 Jobs Act Conference Report, at 320.

(2) "Redetermined deductions" are defined as deductions of a taxable REIT subsidiary to the extent that the amount of such deductions "would be" decreased under section 482 to clearly reflect income.

(3) "Excess interest" is defined as deductions for interest payments by a taxable REIT subsidiary to the REIT to the extent the interest rate exceeds a commercially reasonable rate.

b. Under section 857(b)(7)(E), the imposition of the 100% tax under section 857(b)(7) and the imposition of tax under section 482 are mutually exclusive.

8. Excise tax on undistributed income

The REIT is subject to an excise tax on undistributed income. The amount of the excise tax is 4 percent of the excess of (1) 85 percent of the REIT's ordinary income plus 95 percent of the REIT's net capital gain, over (2) the amount distributed. This amount will be increased by amounts not distributed in the preceding year. Section 4981.

9. Penalty for Failure to Comply with Reporting Requirements

Prior to the 1997 Act, a REIT could be disqualified if it failed to comply with Treasury regulations governing the ascertainment of its ownership. The 1997 Act provides an "intermediate" penalty of $25,000 ($50,000 in the case of intentional disregard) for any year the REIT fails to comply. Section 857(f).

10. See Example #17, infra.

C. Taxation of REIT Shareholders

1. Ordinary income dividends

REIT dividends of ordinary income are includible in gross income, to the extent of the REIT's earnings and profits. Treas. Reg. § 1.857-6(a). See section 857(d).

Section 1(h)(11) provides that "qualified dividend income" is taxed as capital gain instead of ordinary income. Dividends distributed by REITs are "qualified dividend income," but are subject to the limitations of section 857(c)(2), which include the limits of section 854(b)(1)(B) and (C) that are applicable to RIC dividends.

2. Capital gain dividends

REIT dividends of capital gain are taxable to shareholders as long term capital gain, regardless of holding period. Section 857(b)(3)(B). Capital gain dividends must be so designated by written notice to shareholders.

Shareholders are taxed on the capital gain dividends at the capital gains rates of section 1(h).

3. Year in which dividends are taxable

a. Generally, amounts paid to REIT shareholders are taxable to the shareholders in the year received. Treas. Reg. § 1.857-6(a). See section 858(b).

b. Section 857(b)(9) provides that dividends declared and payable to shareholders of record on a date during the last three months of a calendar year (and actually paid during January of the following calendar year) are deemed paid on December 31 of that calendar year.

4. Sales of REIT shares

   a. In general, sales of REIT shares are treated like sales of other capital assets.

   b. However, if REIT shares are held for 6 months or less, and then sold at a loss, then the loss, to the extent of any capital gain dividend received, shall be a long-term capital loss. Section 857(b)(8).

TAXATION OF REAL ESTATE MORTGAGE CONDUITS (REMICs)

I. Taxation of Real Estate Mortgage Investment Conduits

A. Qualification as a REMIC

1. REMICs are fixed pools of mortgages, in which investors hold various classes of interests.

2. Eligible entities

The REMIC may be a corporation, a trust, a partnership, or other entity. Section 860D.

3. Election of REMIC status

a. Section 860D(a)(1) requires that an entity must elect REMIC status.

b. Section 860D(b) governs the election, and provides rules applicable to inadvertent terminations. Treas. Reg. § 1.860D-1(d).

4. "Interest" composition requirements

a. The REMIC must issue only regular and residual interests. Section 860D(a)(2). Treas. Reg. § 1.860D-1.

b. Regular interests

(1) Regular interests may be issued in the form of debt, stock, partnership or trust interests, etc.

(2) Regardless of their form, regular interests are treated like debt instruments. Section 860B.

(3) The terms of the regular interest must be fixed on the "startup day." Section 860G(a)(1).

(4) The terms of the regular interest must entitle the holder to receive a specified principal amount. Section 860G(a)(1)(A).

(a) Section 835(b)(5)(A) allows a REMIC interest to qualify as a regular interest despite the fact that the specified principal amount of the interest (or the amount of interest accrued on the regular interest) can be reduced as a result of the nonoccurrence of one or more contingent payments with respect to a reverse mortgage loan held by the REMIC, so long as the REMIC sponsor "reasonably believes" that all principal and interest due under the regular interest will be paid on or before the date the REMIC liquidates.

(5) Interest payments may be based on a fixed or variable rate. Section 860G(a)(1)(B)(i). See IRS Notice 87-41, 1987-1 C.B. 500; and IRS Notice 87 67, 1987-2 C.B. 377, regarding variable rates. Interest payments may also be based on a specified portion of the interest payments on qualified mortgages, as long as such portion does not vary during the period the regular interest is outstanding. Section 860G(a)(1)(B)(ii).

c. The REMIC must issue only one class of residual interest, and that class must receive distributions on a pro rata basis. Section 860D(a)(3).

d. Residual interests

(1) Residual interests are interests other than regular interests, that are designated as residual interests. Section 860G(a)(2).

(2) Residual interests, regardless of form, are treated as equity interests in the REMIC. Section 860C.

(3) For example, assume the REMIC owns mortgages paying 12 percent and regular interest holders receive 11 percent. The residual interest holders may receive the 1 percent excess interest, plus other gains, less losses.

e. The REMIC must make reasonable arrangements to ensure that its residual interests are not held by certain disqualified organizations. Section 860D(a)(6). Treas. Reg. § 1.860D-I (b)(5).

5. Asset requirements

a. At the close of the 3rd month after the startup day, and at all times thereafter, "substantially all" of the REMIC's assets must consist of "qualified mortgages" and "permitted investments." Section 860D(a)(4).

b. "Qualified mortgages" are defined as (section 860G(a)(3)):

(1) An obligation secured by an interest in real property that is (i) transferred to the REMIC on the startup day in exchange for interests in the REMIC, (ii) purchased by the REMIC within 3 months of the startup day, if such purchase is pursuant to a fixed-price contract in effect on the startup day, or (iii) represents an increase in the principal amount of an obligation described in (i) or (ii) if such increase is attributable to an advance made to the obligor pursuant to the original terms of the obligation, occurs after the startup day, and is purchased by the REMIC pursuant to a fixed price contract in effect on the startup day.

(2) A "qualified replacement mortgage" received (i) within 3 months of the startup day, or (ii) to replace a defective mortgage, within 2 years of the startup day.

(3) A regular interest in another REMIC received on or before the startup day.

(4) On or after September 1, 1997, a regular interest in a FASIT that is (i) transferred to the REMIC on the startup day in exchange for interests in the REMIC, or (ii) purchased by the REMIC within 3 months of the startup day, but only if 95 percent or more of the assets of such FASIT are attributable to obligations which are principally secured by interests in real property.

(5) Section 835 of the 2004 Jobs Act expands the definition of "qualified mortgage."

    (a) Section 835(b)(5)(B) of the 2004 Jobs Act provides that, beginning January 1, 2005, reverse mortgage loans and certain increases in balances on reverse mortgage loans, are treated as obligations secured by an interest in real property.

    (b) Section 835(b)(7) of the 2004 Jobs Act provides that, beginning January 1, 2005, if more than 50% of the obligations transferred to or purchased by a REMIC are U.S. or state obligations principally secured by interests in real property, then each obligation transferred to or purchased by the REMIC shall be treated as secured by an interest in real property.

(6) Modifications to loans

(a) Rev. Proc. 2009-23 provides that the IRS will not challenge the tax status of a REMIC if modifications to certain mortgage loans are made pursuant to the Home Affordable Modification Program (also known as “HAMP”).

(b) Final regulations issued in September 2009 (T.C. 9463) permit certain types of modifications to commercial mortgage loans without jeopardizing REMIC qualification. The regulations provide that the following modifications are permitted so long as the mortgage continues to be principally secured by real property:

i) A release of a lien on real property (Treas. Reg. § 1.860G-2(a)(8)),

ii) Waiver of a due-on-sale clause or a due-on-encumbrance clause (Treas. Reg. § 1.860G-2(b)(3)(iii)),

iii) Conversion of an interest rate by a mortgagor pursuant to the terms of a convertible mortgage (Treas. Reg. § 1.860G-2(b)(3)(iv)),

iv) A modification that releases, substitutes, adds, or otherwise alters a substantial amount of the collateral for, a guarantee on, or other form of credit enhancement for, a recourse or nonrecourse obligation (Treas. Reg. § 1.860G-2(b)(3)(v)), and

v) Changes in the nature of an obligation from nonrecourse to recourse (Treas. Reg. § 1.860G-2(b)(3)(vi)).

(c) Due to the financial issues affecting the banking system in 2009, the IRS issued Rev. Proc. 2009-45. The revenue procedure provides that the IRS will not challenge the qualification of a REMIC on grounds that the modifications made to its commercial mortgage loans aren’t among those listed in Treas. Reg. § 1.860G-2(b)(3) as long as (1) the pre-modification loan meets certain requirements, (2) payments on loans were overdue by at least 30 days, and (3) based on all the facts and circumstances, holder or servicer reasonably believes there is significant risk of default on maturity or at an earlier date. Rev. Proc. 2009-45.

c. “Permitted investments” are defined as (section 860G(a)(5)):

(1) Temporary “cash flow investments,” from which the REMIC earns interest.

(2) “Qualified reserve assets,” which are intangible assets held to enable payments in the event of mortgage defaults.

(3) “Foreclosure property,” within the section 856(e) definition.

6. Transfers of property to the REMIC

a. On a transfer of property to the REMIC, in exchange for an interest, no gain or loss is recognized by the transferor. Section 860F(b)(1)(A). Treas. Reg. § 1.860F-2.

b. The transferors basis of the interest received in exchange for the transferred property is the basis of the property transferred. Section 860F(b)(1)(B).

c. If a regular interest is received, any nonrecognized gain is taxed under the (market discount) rules of section 1276; any nonrecognized loss is amortized under the (premium amortization) rules of section 171.

d. If a residual interest is received, any nonrecognized gain or loss is ratably recognized.

e. The basis of property received by the REMIC is its fair market value. Section 860F(b)(2).

f. The holder of the REMIC interests will recognize gain or loss on the sale of those interests.

7. Taxes are imposed with respect to residual interests held by disqualified organizations.

a. A tax is imposed on the transfer of residual interests to certain non-taxable disqualified organizations. Section 860E(e)(1). Treas. Reg. § 1.860E-2.

b. Similarly, a tax is imposed on certain pass-through entities in which disqualified organizations hold interests. Section 860E(e)(6).

8. Taxation of REMICs

a. REMICs, in general, are not taxable entities. Like partnerships, they pass through all of their income. Section 860A(a).

b. However, in order that the REMIC's income can be taxed to holders of interests in the REMIC (see below), the REMIC's taxable income must be determined. Treas. Reg. § 1.860C-2.

c. REMICs are subject to a 100 percent tax on net income from prohibited transactions. Section 860F(a).

(1) Prohibited transactions include most dispositions of qualified mortgages, receipt of income from nonpermitted assets, receipt of compensation for services, and dispositions of cash flow investments other than pursuant to liquidation. "Cash flow investments" are investments of amounts received under qualified mortgages made for a temporary period before distribution to the owners of the REMIC. Section 860G(a)(6).

(2) This tax is designed to ensure that REMICs are passive entities.

d. REMICs also are subject to tax on net income from foreclosure property. Section 860G(c).

e. In addition, REMIC's are subject to a 100 percent tax on certain contributions made after the startup day. Section 860G(d). Exceptions are provided for certain cash contributions.

9. Taxation of regular interest holders

a. Holders of regular interests are taxed as if they held a debt instrument. Section 860B.

b. Income on the interest must be determined on the accrual basis. Income may include qualified stated interest ("QSI") as well as original issue discount ("OID"). The IRS has proposed regulations prescribing rules relating to the accrual of OID) on REMIC regular interests. Notice of Proposed Rulemaking, 2004 Fed (CCH) ¶49,610 (Aug. 25, 2004).

c. Upon disposition of a regular interest, gain constitutes ordinary income to the extent of a portion of unaccrued OID.

10. Taxation of residual interest holders

a. Holders of residual interests are taxed, currently, on their share of all of the taxable income of the REMIC not taken into account by regular interest holders. Section 860C. Amounts are taxed as ordinary income or loss. Section 860C(e)(1).

b. Income taxed to a residual interest holder increases his basis in the interest. REMIC losses decrease basis. Section 860C(d).

c. Section 860E(a) provides rules for “excess inclusions,” under which a portion of the residual income of most residual interest holders cannot be offset by business deductions or NOLs of the holder. Treas. Reg. § 1.860E-1.

d. Distributions by a REMIC are income to the holder only if they exceed the holder’s basis in the residual interest. Distributions reduce the holder’s basis in the residual interest. Distributions in excess of such basis are treated as gain from the sale of the interest. Section 860C(c).

e. Losses are allowable only to the extent of a holder’s basis in his residual interest. Disallowed losses carry forward indefinitely. Section 860C(e)(2).

f. Certain residual interests are called non-economic residual interests (“NERIs”). These interests are defined in Treas. Reg. § 1.860E-1(c)(2).

(1) NERIs generally have a negative value when acquired and, thus, NERI buyers generally receive inducement fees to purchase such interests. The IRS requires that, in order to clearly reflect income, the holder of a NERI interest in a REMIC is required to include the inducement fee in income over a period “reasonably related” to the period during which the applicable REMIC is expected to generate taxable income or net loss allocable to the holder of the NERI. Beginning May 11, 2004, two safe harbor methods of accounting for these fees are available: the “book method” and the “modified REMIC regulatory method.” Treas. Reg. § 1.4466(e). A taxpayer may adopt either of these safe harbor methods under the automatic consent procedures for changing methods of accounting, as modified by Rev. Proc. 2004-30, 2004-21 I.R.B. 950.

(2) The IRS has identified certain sales of NERI interests as aggressive tax shelters. See IRS News Release 2004-97, 2004 I.R.B. LEXIS 324 (July 26, 2004).

TAXATION OF FINANCIAL ASSET SECURITIZATION TRUSTS (FASITs)

Note: The FASIT rules were repealed in 2004, effective January 1, 2005. However, the rules continue to apply to FASITs that existed on October 22, 2004.

I. Taxation of Financial Asset Securitization Investment Trusts

A. Qualification as a FASIT

1. FASITs are trusts that facilitate the securitization of debt obligations such as credit card receivables, home equity loans, and auto loans. See Announcement 96-121, 1996-47 I.R.B. 12. Proposed regulations under sections 860H through 860L were issued in February 2000.

2. Eligible entities

FASITs are statutory, pass-through entities. Any entity (corporation, partnership, trust, or segregated pool of assets) is eligible. Section 860L(a).

3. Election of FASIT status

a. Section 860L(a)(1)(A) requires that FASIT status be elected. See also, Prop. Treas. Reg. §1.860H-1(b).

b. Section 860L(a)(3) governs the election, which is irrevocable without IRS consent. Rules are provided for terminations and inadvertent terminations.

4. Interest composition requirements

a. Regular interests

(1) Regular interests are treated as debt instruments, with income determined under the accrual accounting method. Section 860H(c).

(2) The interest must have fixed terms that specify a principal amount, state a fixed or variable interest rate, and state a maturity date of no more than 30 years. Section 860L(b)(1).

(3) Regular interests include "high-yield" interests. Section 860L(b)(1)(B).

(a) A regular interest is "high-yield" if it yields more than five percentage points above the applicable AFR at the time of issue.

(b) If a holder of a high-yield interest transfers that interest to a "disqualified holder," the transfer is not recognized and the transferor continues to be taxed on the income attributable to the interest. Section 860K(a).

(c) "Disqualified holders" include any holder other than (1) domestic C corporations (other than a RIC, REIT, REMIC or cooperative) (ii) a FASIT or (iii) dealers seeking to resell the interest.

(d) If a pass-through entity holds a high-yield regular interest in an attempt to avoid the disqualified holder rule, a special tax is imposed on the entity. Section 860K(e).

b. Ownership interest

The ownership interest must be held by a non-exempt domestic C corporation (other than a RIC, REIT, REMIC or cooperative). Sections 860L(a)(1)(C), 860L(a)(2) and 860L(b)(2). Prop. Treas. Reg. §1.860H-I(a)(1).

5. Asset requirements

a. At the close of the third month after formation and thereafter, substantially all of the FASIT's assets must be "permitted assets." Section 860L(a)(1)(D). Proposed regulations define "substantially all" of the FASIT's assets as assets the total adjusted bases of which constitute 99% of the total adjusted bases of all assets held by the FASIT. Prop. Treas. Reg. §1.860H-2(a).

b. "Permitted assets" include cash and equivalents, permitted debt instruments, foreclosure property, and hedges. Section 860L(c).

(1) "Cash and cash equivalents" is defined to include: U.S. dollars; other currency; certain debt instruments; and money market shares. Prop. Treas. Reg. §1.860H-2(c).

(2) "Permitted debt instruments" is defined to include: certain fixed rate debt instruments; certain variable interest rate debt instruments; REMIC regular interests; FASIT regular interests; certain inflation indexed debt instruments; certain receivables generated through revolving credit agreements;

certain stripped bonds or stripped coupons; and certificates of trust representing beneficial interests in the above-listed debt instruments. Prop. Treas. Reg. §1.860H-2(b)(1).

(3) “Foreclosure property” is property acquired in connection with the default or imminent default of a debt instrument held by a FASIT. Prop. Treas. Reg. § 1.860H-2(f).

(4) A “permitted hedge” or guarantee contract is one that is reasonably required to offset any differences in amounts or timing that any risk factor may cause between the FASIT’s receipts on assets and its payments on regular interests. Permitted hedges and guarantee contracts may include contracts issued by the holder of the ownership interest in the FASIT. Prop. Treas. Reg. §1.860H-2(d).

(5) “Permitted assets” may be acquired at any time, including after the formation of the FASIT.

6. Transfers of property to the FASIT

a. When the holder of the ownership interest in a FASIT (or a related person) contributes property to the FASIT, the holder will recognize gain immediately. Section 8601(a)(1).

b. If any other party transfers assets to the FASIT, the assets will be considered acquired by the holder of the ownership interest and sold by that holder to the FASIT. Section 860I(a)(2).

c. If any assets of the holder of the ownership interest are used to support (to pay or to collateralize) regular interests, those assets are treated as sold to the FASIT. Section 8601(b).

d. The IRS may issue regulations to defer this gain. Section 860I(c). No provisions for deferral have been proposed. <u>See</u> Prop. Treas. Reg. §1.8601-1(d).

e. The basis of any property on which gain is recognized under section 8601 is increased by the amount of the gain recognized. Section 860I(e)(2).

f. Losses on assets contributed to the FASIT are not currently allowed, but may be allowed to the holder upon the disposition of the asset by the FASIT.

B. Taxation of FASITs

1. The FASIT is not a taxable entity. Section 860H(a).

2. The FASIT is taxed on prohibited transactions. Section 860L(e). The tax equals 100 percent of the net income from the prohibited transaction. Generally, a prohibited transaction includes income from other than permitted assets, other than permitted dispositions, and certain other prohibited activities, including loan origination by the FASIT. See Prop. Treas. Reg. § 1.860L-1.

C. Taxation of regular interest holders

1. Holders of regular interests are taxed as if they held a debt instrument. Section 860H(c)(1).

2. Income attributable to the regular interest is determined on the accrual basis. Section 860H(c)(3).

D. Taxation of ownership interest holders

1. All of the assets, liabilities, income, deductions, credits, etc., of the FASIT are treated as being currently that of the ownership interest holder. Section 860H(b)(1). See also, Prop. Treas. Reg. §1.860H6.

2. The income taxed to the ownership interest holder generally equals the difference between the interest the FASIT earns from its loan portfolio and the interest the FASIT pays to its regular interest holders.

3. The character of the income to the holder is the same as the character to the FASIT, except that tax-exempt interest is treated by the holder as ordinary income. Section 860H(b)(4).

4. Specific rules apply to holders of "high-yield" regular interests and to the holders of ownership interests. Section 860J.

   a. The holder cannot offset income or gain from the FASIT with any non-FASIT losses. Section 860J(a). See also, Prop. Treas. Reg. §1.860J-1.

   b. The holder cannot offset any FASIT "excess income inclusion" with any non-FASIT losses. Section 860J(a).

   c. Any NOL carryover is computed by disregarding any income arising by reason of the disallowed loss. Section 860J(b).

E. Cessation of FASIT Status

1. If an entity or arrangement revokes its election to be classified as a FASIT, or if the FASIT fails to qualify as a FASIT (and the failure is not determined to be inadvertent), the entity continues to hold the assets of the FASIT with a fair market value basis. Prop. Treas. Reg. §1.860H-4(c).

2. Upon cessation of a FASIT, the holder of the ownership interest is treated as exchanging the assets of the FASIT for their value as determined under the proposed regulations. Prop. Treas. Reg. §§1.860H-4(c)(2) and 1.8601-2.

   a. Gain from the exchange is treated as income from a prohibited transaction, subject to the tax imposed by section 860L(e). Losses, if any, are disallowed.

3. Upon cessation of a FASIT, the holders of regular interests are treated as exchanging their regular interests in the FASIT for interests in the underlying arrangement. Prop. Treas. Reg. §1.860H-4(c)(3).

   a. Gain is recognized if the owner of a regular interest receives a non-debt interest in the underlying arrangement or a "materially different" debt interest in the underlying arrangement.

F. Anti-Abuse Rules

1. Section 860L(h) gives the Secretary authority to prescribe regulations to prevent abuse of the purposes of the FASIT rules through transactions which are not primarily related to securitization of debt instruments by a FASIT. See Prop. Treas. Reg. §1.860L-2.

G. Section 835 of the 2004 Jobs Act repealed the FASIT rules for tax years beginning on or after January 1, 2005. The rules will continue to apply to existing FASTs, to the extent that regular interests in such FASITs remain outstanding in accordance with the "original terms of issuance."

TAXATION OF PROPERTY AND CASUALTY (P&C) INSURANCE COMPANIES

I. General Considerations

A. Types of organizations -- P&C insurers are primarily chartered under state law as stock or mutual companies.

B. Economic functions

1. Underwriting -- Issuance of property and liability insurance (automobile, casualty, fire, malpractice, title, accident and health, etc.)

2. Investment -- Invest primarily in bonds, including tax-exempt bonds, and corporate stock.

II. Major Tax Concepts

A. Should special rules apply to property and casualty insurance companies? If so, what special rules should apply?

B. Policy obligations generally are short term, as opposed to the long-term policy obligations of life insurers. The short-term nature of the liabilities is reflected in the types of reserves held.

C. The tax accounting principles (TAP) applicable to property and casualty insurance companies are greatly affected by the statutory accounting principles (SAP) applicable to those companies. Statutory accounting principles are analogous to, but differ from, generally accepted accounting principles (GAAP). See Treas. Reg. § 1.832-4(a)(1) & (2).

D. P&C's generally are taxed on both their investment and underwriting income. The computation of underwriting income involves two key elements: (1) unearned premiums, and (2) losses and expenses incurred.

1. Reserves for unearned premiums

a. A P&C insurer includes in income only the portion of premiums that has been "earned" (but, see below).

b. As of any year end, the "unearned" portion of any premium is the amount attributable to the unexpired term of the policy -- the portion which would be returned if the policy were cancelled.

c. Note that ordinary taxpayers are subject to the claim of right doctrine and are not similarly entitled to defer income. AAA v.

U.S., 367 U.S. 687 (1961); RCA Corp. v. U.S., 664 F.2d 881 (2d Cir. 1981).

d. Courts have held that unearned premium reserves may also include other amounts, such as a reserve for retrospective rate refunds. Bituminous Casualty Corp. v. Comm'r, 57 T.C. 58 (1971). Regulations now provide that such "retro credits" are excluded from unearned premium reserves. Treas. Reg. § 1.832-4(a)(8).

e. Unlike other casualty insurers, a title insurance company can be considered to have earned the entire premium upon payment. Also, no part of the premium is refundable, even if the title insurance policy is canceled. However, state law usually requires that a portion of the premiums received be set aside. The IRS does not consider that portion to be an unearned premium. Rev. Rul. 83-174, 1983-2 C.B. 108. For tax years beginning after December 31, 1986, however, section 832(b)(8) provides a special rule for calculating the "discounted unearned premiums" of a title insurance company. See Rev. Rul. 91-22, 1991-1 C.B. 91.

2. Reserves for unpaid losses

a. A P&C insurer may deduct from income its "losses incurred." A loss is incurred when the event that is insured against occurs.

In Sears, Roebuck & Co. v. Comm'r, 96 T.C. 61 (1991), rev'd, 972 F.2d 858 (7th Cir. 1992), the courts considered the issue of when a loss is incurred in the context of mortgage guarantee insurance -- when the borrower defaults or when the lender secures title to the mortgaged property. See also AIG, Inc. v. U.S., 38 Fed. Cl. 272 (1997).

b. The term "incurred" is far broader than the term "accrued" and, unlike the term "accrued," does not rely on the "all events test." Moreover, section 461(h) should not apply to incurred losses.

c. Losses incurred include (both actual and anticipated) claims payments for benefits under policies that have been:

Reported (or case) losses:

- incurred, reported, adjusted, and paid

-incurred, reported, adjusted, but not yet paid (even if the claim is resisted)

-incurred, reported, but not yet adjusted

IBNR losses:

-incurred, but not yet reported

d. Reserves for unpaid losses must be "a fair and reasonable estimate of the amount that the company will be required to pay." Treas. Reg. § 1.832-4(b).

(1) In Utah Medical Ins. Ass'n v. Comm'r, 76 TCM (CCH) 1100 (1998), the Tax Court held that a medical malpractice insurer's estimates for reserves for unpaid losses were "fair and reasonable." The Tax Court accorded deference to the opinion of the taxpayer's expert actuary, who was also the taxpayer's actuary during the years in issue.

(2) But see, Minnesota Lawyers Mutual Ins. Co. v. Comm'r, 79 TCM (CCH) 2234 (2000), aff'd, 285 F.3d 1086 (8th Cir. 2002), where the Tax Court held that a portion of a professional liability insurer's estimates for unpaid loss reserves was not "fair and reasonable." The portion of the reserves that was found not to be fair and reasonable was called the "adverse loss development" reserve, which was (1) a bulk reserve (i.e., it was not case-specific), (2) established by the insurer's CEO and President, not the company's actuaries, and (3) increased the insurer's unpaid loss reserves by 37 to 50 percent.

e. Unpaid loss reserves for reported losses are based either upon an average value or statistical method, or upon the facts of the specific reported claims. IBNR reserves are estimated, based on experience, as a percentage of insurance in force.

f. The IRS will test unpaid loss reserves to determine the reasonableness of their estimation.

g. The IRS first relied on the "Closed Case Method."

(1) The method tests the portion of the reserve computed on the individual case (not the formula) basis.

(2) The test identifies cases that are open as of the end of each year during a three-year period that ends five years prior to the audit year.

(3) The amounts of the loss estimates in the cases that close during the five-year development period are compared to actual payments on those closed cases made in years through the audit year. (Cases still open are disregarded.)

(4) That comparison creates an experience rate. For example, if on a case a $1,000 loss was estimated, and $800 was paid, the experience rate is 125 percent. (25 percent over-reserving.)

(5) The experience rate is applied to the unpaid loss reserves in the audit year.

(6) <u>See</u> Example #18, <u>infra</u>.

(7) Note: The test is applied separately to each line of business. The test may be modified in various ways. An insurer may be able to rebut proposed adjustments by developing the reserves for the year in audit.

(8) IBNR reserves also are tested. For example, for 1993, test claims incurred during or before 1993, but not reported until after 1993.

h. The IRS's view of the test

(1) Most claims that will be paid are paid within the five year development period. Any payments made after that period also can be considered.

(2) Allowing addition of an estimate as to amounts that will be paid after five years would be inaccurate ("testing an estimate with an estimate"). <u>See</u> LTR 8817001 (July 28, 1987).

i. The P&C company view of the test

(1) Many claims are not paid within the five year period. Some types of cases, in the "long-tail" lines of business, often are closed later. Any test should allow for this.

(2) Payments in "short-tail" cases are more likely to be less than or equal to the loss estimate. Schedule O lines (fire, theft, auto physical damage, and group A&H) are usually short-tail.

(3) Payments in "long-tail" cases are more likely to exceed the loss estimate. (Inflation, more hotly contested claims, larger claims.) Schedule P lines (auto liability, medical malpractice, workmen's comp.) are usually long-tail.

(4) The method ignores cases that are "open," yet which are making payments over time (for example, workmen's compensation cases).

(5) Since the method only tests case reserves, it ignores IBNR reserves.

(6) The test requires payments be reduced by salvage and subrogation recovered. This skews the results, since the losses incurred reserves must be estimated without considering such recoveries.

(7) There should be a tolerance factor.

j. Under a "Modified Closed Case Method," announced by the IRS in response to various criticisms, some of the foregoing concerns were addressed. See "IRS' Coordinated Issues List for Property/Casualty Insurance Companies is Available," 90 Tax Notes Today 158-11(July 31, 1990). However, many of the same problems continued to exist.

k. Currently, the most commonly used method is the "Age-to Ultimate Method," or the "Paid Loss Extrapolation Method."

(1) The theory of the method is that, because losses develop according to a pattern that remains relatively constant from year-to-year (a key assumption), the actual development of paid losses at any time can be extrapolated to the ultimate total of losses to be paid.

(2) The method depends on creating a matrix of developed losses at successive stages, referred to as the "loss development pattern." This pattern will show that X% of losses are paid after one year, Y% of losses are paid after two years, etc.

(3) Using this pattern, it is possible to estimate the amount of losses that ultimately will be paid.

(4) The amount of the reserve being held should equal the ultimate amount of losses minus the amount of losses already developed. If the reserve exceeds that amount, the IRS may claim that the reserve is redundant.

(5) See Example #19, infra.

(6) The Age-to-Ultimate Method also has shortcomings. Primarily, it is based on the assumption that previous loss

payment patterns accurately reflect more current patterns. However, various factors may undermine that assumption.

3. Reserves for unpaid loss adjustment expenses (LAE)

   a. A P&C insurer may deduct loss adjustment expenses.

      (1) LAE are expenses of adjusting, recording, and paying policy claims. (Such as employee salaries, legal fees, etc.)

      (2) LAE are either "allocated" or "unallocated" expenses. Allocated LAE are directly attributable to specific cases. Unallocated LAE are general overhead-type expenses.

      (3) LAE are either "paid" or "unpaid." Unpaid LAE are estimates of future expenses to be incurred in connection with unpaid losses.

   b. Estimates of unpaid LAE are deductible, even though such expenses do not meet the all events test. Section 461(h) does not apply.

   c. LAE estimates are usually prepared on a formula basis. A ratio is determined, based on prior years' numbers, of paid LAE to paid losses. That ratio is then applied to the current year reserve for unpaid losses.

   d. The IRS will test estimates of unpaid LAE. Generally, the test applies a paid expense/paid loss ratio to adjusted reserves for unpaid losses.

E. These two elements -- unearned premiums and losses incurred -- have figured prominently in the taxation of P&C insurance companies over the years.

1. Prior to the 1986 Act, the Code utilized annual statement amounts. Under these Code provisions, companies could fully defer unearned premiums, and fully deduct estimated unpaid losses and LAE.

2. In an attempt to match income with expenses, and to reflect the time value of money, the 1986 Act significantly altered the taxation of reserves for unearned premiums and reserves for unpaid losses and loss adjustment expenses, for years after 1986. (See discussion below.)

III. Income Subject to Tax

A. In General

1. P&C companies are insurance companies that do not qualify as life insurance companies under section 816.

2. HMOs, other than staff model HMOs, can qualify as P&C insurance companies. Rev. Rul. 68-27, 1968-1 C.B. 315; LTR 9412002 (Dec. 17, 1993). However, the IRS has taken the position that a company jointly owned by an HMO and physicians is not an insurance company, because the predominant business activity of the company is the provision of medical services. FSA 200104011 (Oct. 19, 2000).

3. Extended warranty providers for automobiles and other manufactured products can qualify as P&C insurance companies if they (1) bear the economic risk of loss on the contracts and (2) do not directly provide the warranted services. See, e.g., LTR 200028018 (Apr. 14, 2000) (extended product warranty company); LTR 200042018 (July 21, 2000) (extended auto warranty company); LTR 200140057 (July 9, 2001) (extended warranty company that issues auto, plumbing, electrical, and heating contracts); LTR 200242027 (July 17, 2002) (extended auto service and tire contract company); LTR 200237010 (June 5, 2002) (extended auto warranty company).

B. Accounting Methods

1. P&C insurers do not use either the cash method or the accrual method of accounting. Instead, they base their taxable income (section 832(b)(1)) and expenses (section 832(b)(6)) on their NAIC annual statements. Treas. Reg. § 1.832-4(a)(1) & (2). See Home Group, Inc. v. Comm'r, 89-1 U.S.T.C. ¶9329 (2d Cir. 1989).

2. Taxable income so computed is subject to tax as provided in section 11. Section 831(a).

C. Two Alternatives for Small Companies

1. Instead of being subject to tax on their regular taxable income, certain small companies (either stock or mutual) may be exempt from tax or, if not exempt, may elect to be taxed on their "taxable investment income." Sections 501(c)(15) and 831(b).

2. These two provisions, which were enacted in the 1986 Act, replace prior provisions that gave special treatment to small mutuals. Former sections 501(c)(15), 821, and 824.

3. First, certain P&C insurers may be exempt from tax under section 501(c)(15).

   a. For tax years beginning on or after January 1, 2004, a P&C insurer generally must meet three tests to qualify for tax-exemption: (1) it must qualify as an "insurance company" as defined in section 816(a); (2) its gross receipts must not exceed $600,000; and (3) more than 50% of its gross receipts must be premiums. For mutual insurance companies, the gross receipts limit is reduced to $150,000 and the percent of premiums requirement is reduced to 35%. Certain related person and related entity rules apply for purposes of these tests. <u>See</u> <u>also</u>, IRS Notice 2004-64, 2004-41 I.R.B. 598 (alerting taxpayers to amendments to section 501(c)(15)).

   b. For tax years beginning before January 1, 2004, P&C insurers that receive premiums during the year in the amount of $350,000 or less qualify as tax-exempt organizations under section 501(c)(15).

4. Second, P&C insurers that receive premiums of less than $1,200,000 for a taxable year may elect to be taxed on their "taxable investment income." Section 831(b)(2). For tax years prior to 2004, a company must also receive premiums of more than $350,000. This requirement was eliminated by the Pension Funding Equity Act of 2004.

   a. Taxable investment income is defined as "gross investment income" less specified investment-type deductions. Section 834.

   b. Taxable investment income for P&C insurers is very similar to Phase I income of life insurers under the 1959 Act. Former section 804. It is somewhat analogous to current sections 812(c) and (d) applicable to life insurance companies.

   c. Rules are provided to aggregate the incomes of members of a "controlled group." Section 831(b)(2)(B).

IV. <u>Insurance Company Taxable Income</u>

A. P&C insurance companies generally are subject to tax on their "taxable incomes." Section 831(a). Taxable income is computed as "gross income" less various deductions. Section 832(a).

B. "Gross income" is the sum of the items specified in section 832(b)(1). Generally, these items are:

   1. Investment income.

   2. Underwriting income.

3. Gains from dispositions of property.

4. Other items of gross income.

C. "Investment income" is the sum of the interest, dividends, and rent received, plus the increase in the accrual for such items of income. Section 832(b)(1)(A) and 832(b)(2).

1. These items are computed on the basis of the company's NAIC annual statement.

2. Many issues concerning, for example, accrual of discount and amortization of premium, arise in this area.

D. "Underwriting income" is computed as "premiums earned" less "losses incurred" and "expenses incurred." Section 832(b)(1)(A) and 832(b)(3).

1. Premiums earned

a. In general, only 80 percent of the increase in the unearned premium reserve may be deducted. Section 832(b)(4)(B).[5]

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[5] Under pre-1986 Act law, earned premiums equaled gross premiums written less the sum of (1) premiums paid for reinsurance, (2) return premiums (for errors, policy cancellations, etc.), and (3) the increase in the reserve for unearned premiums (see above). The reserve amounts were as reported on the NAIC annual statement.

As part of the change to the 80% method, the reserve for unearned premiums as of year-end 1986 is reduced by 20 percent, and that amount is included in income ratably over a 6-year period, from 1987 until 1992; i.e., 3-1/3 percent of the year-end 1986 reserve per year. Section 832(b)(4)(C). Thus, no "fresh start" is provided, except for title insurers.

Section 832(b)(7)(D) waives such inclusion for a company exempt from tax in pre-1987 years.

Treatment of companies' pre-1963 unearned premium balance

1. Some mutual companies were exempt from tax prior to 1963 and, therefore, their pre-1963 unearned premium reserves provided no tax benefit.

2. These companies object to having 20% of their unearned premium reserves brought into income to the extent of their pre-1963 reserves.

3. The IRS counters that the year-end 1986 reserves reflect no unearned premiums from 1963.

b. What is included in "Premiums Written" for a given tax year?

Treas. Reg. §1.832-4(a)(4)(i) defines gross premiums written as "all amounts payable for the effective period of the insurance contract." Under Treas. Reg. § 1.832-4(a)(4) and (5) the following items are included in gross premiums written:

(1) Premiums actually received during the year. Treas. Reg. §1.832-4(a)(5)(i).

(a) The regulations also appear to require that premiums attributable to an insurance contract that has an effective date during a tax year be included in premiums written for that year, even if the premiums are not received by the insurance company until a later year. Treas. Reg. §1.832-4(a)(5)(i).

(2) Premiums payable in installments. <u>See</u>, <u>e.g.</u>, Treas. Reg. §1.832-4(a)(10), Example 1.

If premiums on an insurance contract are payable in installments, the full amount of the installments attributable to the effective coverage period (<u>e.g.</u>, a one year period on an annually renewable contract, or a longer contract with 12 month rate guarantees) must be included in premiums written for the tax year that includes the effective date of coverage, even if an installment or installments will be received in a later year.

(a) An exception to this reporting rule for installment payments is available for cancellable accident and health ("A&H") insurance contracts with effective periods of 12 months or less. Treas. Reg. § 1.832-4(a)(5)(iv). Under the exception, an installment premium on a cancellable A&H contract is reportable in the earlier of (1) the tax year in which the installment premium is due, or (2) the tax year in which the installment premium is received.

This 20% reduction provision does not apply to life insurance reserves that are included in unearned premium reserves. Section 832(b)(7)(A). As to premiums on these life insurance contracts, <u>see</u> the section 848 DAC rules, discussed infra.

In the case of certain insurance on securities, the reduction is only 10 percent. Section 832(b)(7)(B).

(b) In order to qualify for this exception, the insurance company's deductions for premium acquisition expenses (e.g., commissions, state premium taxes) related to its cancellable A&H contracts with installment premiums, are limited. Treas. Reg. §1.832-4(a)(5)(vii). See, e.g., Treas. Reg. § 1.832-4(a)(10), Example 5. See also, Rev. Proc. 2002-46, 2002-28 I.R.B. 1 (providing a safe harbor method for determining a company's premium acquisition expenses, and providing change in method of accounting rules for use of safe harbor method). An insurance company that adopts the method of reporting allowed by this exception must apply that method to all of its cancelable A&H insurance contracts.

(c) The IRS has ruled that insurance contracts issued to states to cover their obligations under Medicaid benefit programs qualify as cancellable A&H contracts under the regulations. LTR 200044028 (Aug. 7, 2000).

(3) Advance premiums. Treas. Reg. § 1.832-4(a)(5)(i) and (iii).

(a) Treas. Reg. § 1.832-4(a)(5)(i) requires that if an advance premium is received, the full gross premium due must be reported as premium written, and as unearned premium. This is required regardless of annual statement treatment.[6]

(b) An exception to this reporting rule for advance premiums is available. Treas. Reg. § 1.832-4(a)(5)(iii). Under this exception, only the amount of the advance premium is includible in taxable income for the year in which it is received. The remainder of the full premium is included in income for the taxable year that includes the effective date of the contract. See, e.g., Treas. Reg. §1.832-4(a)(10), Example 3.

[6] Formerly, on the annual statement, advance premiums (i.e., premiums received prior to the effective date of insurance coverage) were recorded as written premiums, and then as unearned premiums. Now, companies can place advance premiums in a suspense account and report a write-in liability.

(c) Similar to the rule applicable to installment premiums, in order to qualify for this exception, the insurance company's deductions for premium acquisition expenses (e.g., commissions, state premium taxes) are limited. Treas. Reg. § 1.832-4(a)(5)(vii). See also, Rev. Proc. 2002-46 (providing safe harbor method for determining premium acquisition expenses). An insurance company that adopts the method of reporting allowed by this exception must apply that method to all contracts with advance premiums.

(4) Additional Premiums Due to Increases in Risk Exposure.

(a) Methods of reporting indeterminate premiums on policies with fluctuating risks.

i) Some insurance policies do not have premiums fixed in advance, but premiums that vary with factors subsequently determined (e.g., number of employees). Nevertheless, premiums are billed and paid periodically. There are two methods to account for this.

ii) Under the "Eastern Method," the company includes in gross premiums an estimated annual premium, and includes the unbilled portion of the estimated premium in unearned premiums.

iii) Under the "Western Method," the company includes amounts in gross premiums only as the amounts are billed. Since amounts billed are for prior coverage, there are no unearned premiums.

iv) Thus, the "Western Method" avoids the 20% unearned premium reduction.

(b) The IRS's regulations reject the "Western Method."

(c) Treas. Reg. §§ 1.832-4(a)(4)(ii)(A) and (a)(5)(ii) require that additional premiums charged and/or received due to increases in risk exposure are included in gross premiums written.

(d) Treas. Reg. §1.832-4(a)(5)(ii) provides that the full amount of additional premiums due to changes in risk exposure are included in gross premiums written for the taxable year in which the change in risk exposure occurs. See, e.g., Treas. Reg. §1.832-4(a)(10), Example 6.

i) The regulations contain an exception to this reporting rule for additional premiums due to a change in risk exposure, if the change in risk exposure is of temporary duration. Treas. Reg. § 1.832-4(a)(5)(ii). See, e.g., Treas. Reg. § 1.832-4(a)(10), Example 7.

(5) Amounts subtracted from a premium stabilization reserve to pay for insurance coverage. Treas. Reg. § 1.832-4(a)(4)(ii)(B).

(6) Consideration in respect of assuming insurance liabilities not issued by the taxpayer (e.g., payments of cash or transfers of property received in an assumption reinsurance transaction). Treas. Reg. § 1.832-4(a)(4)(ii)(C).

c. Gross premiums written are reduced by return premiums. Section 832(b)(4)(A); Treas. Reg. §1.832-4(a)(3).

(1) "Return premiums" are amounts previously included in the insurance company's gross premiums written which are refundable to the policyholder (or ceding insurance company, if for reinsurance) and fixed by the insurance contract, i.e., they do not have the characteristics of policyholder dividends. Treas. Reg. § 1.832-4(a)(6)(i).

(2) Return premiums include (1) amounts paid as premiums that are refundable by the insurance company due to policy cancellations or reduced risk exposure; (2) amounts reflecting the unearned portion of unpaid premiums that are refundable due to policy cancellations or reduced risk exposure; and (3) amounts paid or amounts reflecting the unearned portion of unpaid premiums for an insurance contract arising from the redetermination of a premium due to correction of posting or other errors. Treas. Reg. § 1.832-4(a)(6)(ii).

(3) Return premiums attributable to the cancellation of an insurance contract are reported for the year in which the contract is cancelled. Return premiums attributable to

reduced risk exposure are reported for the year in which the reduction occurs.

(4) The IRS has ruled that increases in premium stabilization reserves for group accident and health contracts are deductible as return premiums. Rev. Rul. 2005-33; LTR 200116041 (Jan. 24, 2001).

d. The 80% rule applies to "unearned premiums." What are "Unearned Premiums"?

(1) IRS regulations define "unearned premiums" generally as "the portion of the gross premium written that is attributable to future insurance coverage during the effective period of the insurance contract." Treas. Reg. § 1.832-4(a)(8)(i).

(2) Accounting for "retro credits" and "retro debits" as unearned premiums

(a) Under the regulations, retro credits and retro debits are not included in unearned premium. Treas. Reg. § 1. 832-4(a)(8)(1).[7]

(3) Generally, unearned premiums are determined prorata over the policy period. The proposed regulations suggest that some other result may be required if the risk of loss is not uniform over the policy period. Treas. Reg. §1.832-4(a)(9).

e. Special rules apply to title insurance premiums. Title insurance companies are treated as having unearned premiums. The reserve for unearned premiums is discounted to present value, and the

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[7] In LTR 9647002 (July 29, 1996) and 9648002 (Aug. 2, 1996) the IRS held that the liability to make retrospective refunds is includible in unearned premium reserves.

Prop. Treas. Reg. § 1.832-4(a)(4) provided that retro debits (the additional premiums estimated to be received) must be included in gross premiums written (and not as offsets to unearned premiums). Prop. Treas. Reg. § 1.832-4(a)(5) provided that retro credits (the premiums estimated to be refunded) are included in return premiums (and not in unearned premiums). The final regulations differ from the proposed regulations.

The proposed regulations included a reporting rule for retro credits and retro debits, under which they were to be reported in the year in which they could be "reasonably estimated." The final regulations do not include a specific reporting rule applicable to retro credits and retro debits.

increase in the discounted reserve for the year is deducted from gross premiums. Section 832(b)(8).

(1) The annual statement reserve is discounted using a statutory rate, and reflects the period over which the unearned premiums are to be included in income under state law.

f. A P&C company's reserves for noncan and guaranteed renewable A&H contracts are calculated under 807. Unearned premiums on these contracts are subject to the 20% reduction provision.

g. Example #20 illustrates the computation of "premiums earned."

2. Losses incurred

a. There are three major rules for the determination of losses incurred.[8]

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[8] Under pre-1986 Act law, losses incurred equaled:

1. "Losses paid" (net of salvage and reinsurance received), less

2. The increase in outstanding salvage and reinsurance recoverable with respect to paid losses, plus

3. The increase in the reserve for "unpaid losses."

"Salvage" consists of amounts recovered by the insurer through the sale of damaged property to which it has acquired title.

"Reinsurance" or "subrogation" is the right of the insurer to proceed against third parties for recovery of amounts paid on claims.

The IRS made efforts to require that estimated recoveries of salvage and subrogation attributable to unpaid losses must reduce unpaid losses. Temp. Reg. § 1.832-4T(b). See also Allstate Ins. Co. v. U.S., 936 F.2d 1271 (Fed. Cir. 1991) (effect of tax benefit rule).

In general, P&C insurers (including title insurers) are given a "fresh start" adjustment (a forgiveness of income) for the reduction of the yearend 1986 reserves for unpaid losses and expenses from an undiscounted to a discounted basis. 1986 Act section 1023(e).

If a company "strengthens" reserves in 1986 (thus getting a deduction), the fresh start is denied to the extent of the strengthening. 1986 Act § 1023(e)(3).

Treas. Reg. § 1.846-3 provides that all 1986 increases in estimated losses for pre-1986 accident years constitute reserve strengthening.

b. <u>First</u>, the term "unpaid losses" is defined to include "unpaid loss adjustment expenses" ("LAE") Section 846(f)(2).

(1) Unpaid LAE are deductible under section 832(b)(5) as "losses incurred."[9]

c. <u>Second</u>, the amount included in the losses incurred deduction for "unpaid losses" (other than unpaid losses on life insurance contracts) is limited to the annual increase in discounted reserves for unpaid losses, in order to reflect the time value of money. Sections 832(b)(5)(A)(ii) and 846.

(1) The theory is that an insurer should not be allowed a current $1 deduction for $1 to be paid in the future.

(2) To reflect the time value of money, the current deduction is discounted. (Note that this method of discounting differs from the economic performance rules of section 461(h).)

(3) The present value of the unpaid losses is determined using (<u>see</u> section 846(a)(2)):

(a) The undiscounted unpaid losses reserves,

(b) An assumed interest rate, and

(c) An assumed loss payment pattern.

(d) The NAIC annual statement reserves are a "cap" on the discounted reserves. Section 846(a)(3).

(4) The undiscounted reserves are the reserves per the annual statement. Section 846(b). For a foreign insurance company electing to be taxed as a U.S. corporation under section 953(d), undiscounted unpaid losses reported on its GAAP financial statement may be used. LTR 9811041 (Dec. 11, 1997).

In <u>Western Nat'l Mutual Ins. Co. v. Comm'r</u>, 102 T.C. 338 (1994), <u>aff'd</u>, 65 F.3d 90 (8th Cir. 1995), the regulation was held invalid. However, in <u>Atlantic Mutual Ins. Co. v. Comm'r</u>, 98-1 U.S.T.C. ¶ 50,341 (1998), the Supreme Court affirmed the Third Circuit and held the regulation valid. 523 U.S. 382 (1998).

[9] Under pre-1986 Act law, unpaid LAE were deductible under section 832(b)(6) as "expenses incurred."

(a) If annual statement reserves are already discounted, that discounting can be reversed and disregarded. Treas. Reg. § 1.846-1(a)(3)

(b) If annual statement reserves are reduced for estimated salvage recoverable, that reduction also can be reversed. Treas. Reg. § 1.846-1(a)(4).

(5) The interest rate is a 60-month average of mid-term AFRs. Section 846(c).

(6) A loss payment pattern will be determined by the IRS for 1987, and every five years thereafter, for each line of business on the basis of published aggregate industry data. Section 846(d)(1). <u>See</u> Rev. Proc. 90-23, 1990-1 C.B. 507; Rev. Proc. 92-76, 1992-2 C.B. 453; Rev. Proc. 2004-9, 2004-2 I.R.B. 275 (2003 loss payment patterns).

(a) For Schedule O lines, the pattern will assume payment in the accident year and the following 3 years.

(b) For Schedule P lines, the pattern will assume payment in the accident year and the following 10 years.

(c) For long-tail Schedule P lines, the payment period may be extended by up to 5 additional years.

(7) If an insurer has large enough reserves in a line of business, it may elect to use its own historical payment pattern. Section 846(e). Treas. Reg. § 1.846-2. LTR 9228003 (Mar. 26, 1992).

(8) As noted above, title insurers must discount (under similar rules) their reserves for unearned premiums. Section 832(b)(8). Treas. Reg. § 1.846-1(b)(2). In addition, they must discount their unpaid loss reserves (known as claims reserves).

(9) Under section 847, companies that are required to discount unpaid loss reserves are allowed a special deduction, if they make special estimated tax payments.

d. <u>Third</u>, the total “losses incurred” deduction is reduced by an amount equal to 15 percent of the tax-exempt interest income and the dividends received deductions for the year. Section 832(b)(5)(B).

(1) The theory is that no deduction for losses should be allowed to the extent that such losses are paid with untaxed income.

(2) An exception is provided for certain dividends from affiliated corporations.

(3) There is a grandfather exception for interest and dividends an obligations and stock acquired before August 8, 1986. Section 832(b)(5)(c).

(4) For contracts issued after June 8, 1997, the "prorated amount" also includes the increase for the taxable year in policy cash values of certain corporate owned life insurance policies and annuity and endowment contracts subject to section 264(f). Section 832(b)(5)(B)(iii).

(5) The IRS Office of Chief Counsel has concluded that the amount of tax-exempt interest subject to proration for a taxable year may be reduced by that year's portion of amortizable bond premium attributable to tax-exempt instruments, i.e., only the net amount of exempt income is subject to proration. IRS CCA 200234013 (May 9, 2002).

e. The losses incurred deduction is reduced by the increase in estimated salvage and reinsurance recoverable.[10] 832(b)(5)(A).

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[10] The 1990 Act, for years after 1989, amended section 832(b)(5)(A) to change the treatment of salvage and reinsurance in the computation of losses incurred. See Treas. Reg. § 1.832-4.

As a result of the 1990 Act change in method of accounting for salvage, a section 481 adjustment would ordinarily result. In the case of a company that formerly did not take salvage into account (a "grosser"), the section 481 adjustment would ordinarily equal the amount of discounted salvage and reinsurance recoverable as of December 31, 1989. This amount would have to be included in income.

However, 87% of this amount is given a "fresh start." The balance of 13% must be included in income over a period not to exceed 4 years beginning with 1990. Treas. Reg. § 1.832-4(e)(2).

Some companies, as of 1990, already were reflecting salvage for tax purposes ("netters"). To accord these companies equal treatment, they are allowed to deduct (over 4 years beginning with 1990) 87% of the balance of salvage recoverable as of December 31, 1989. Treas. Reg. § 1.832-4(f).

Some companies reflected salvage for some lines, but not for others. Under the regulations, a company that claims the special deduction cannot also have fresh start relief. Treas. Reg. § 1.832-4(f).

(1) Treasury Regulation § 1.832-4 sets forth the manner in which the discounting calculations are to be performed. <u>See</u> Rev. Proc. 92-72, 1992-2 C.B. 439; Rev. Proc. 2004-10, 2004-2 I.R.B. 288 (2003 salvage discount factors).

f. Example #21 illustrates the computation of "losses incurred".

g. Treatment of uncollectible reinsurance

(1) If a company has reinsured, and the reinsurer has not or is not expected to pay, what is the proper treatment?

(2) Companies would like to include amounts of (and estimates of) unrecoverable reinsurance in losses incurred.

(3) Over the years, the IRS has argued that unrecoverable reinsurance should be deducted as a bad debt. However, this argument was rejected by the IRS National Office in a private letter ruling. LTR 9732004 (Apr. 30, 1997) (uncollectible reinsurance may be written off as part of "losses incurred").

3. Expenses incurred

a. Expenses incurred means all expenses shown on the NAIC annual statement. Section 832(b)(6).

b. Expenses incurred are allowed in an amount equal to "expenses paid," plus the increase in "expenses unpaid" (excluding unpaid LAE).

A company that took salvage into account can elect to "gross up" its December 31, 1989, reserves, and then claim the "fresh start." Treas. Reg. § 1.832-4(d). Rev. Proc. 92-77, 1992-2 C.B. 454. However, the IRS will not permit a company that claimed the special deduction to choose the "fresh start" instead. LTR 9516001 (Dec. 8, 1994).

The IRS has ruled that a "grosser" that makes changes in its statutory accounting method and becomes a "netter" for statutory purposes is not required to recognize income for tax purposes. TAM 200006007 (Sept. 2, 1999).

In <u>Blue Cross & Blue Shield of Texas v. Commissioner</u>, 115 T.C. 148 (2000), the Tax Court held that the differences between what the taxpayer, a health insurance company, would have paid as a primary insurer on all claims and what it actually paid as a secondary insurer (i.e., coordination of benefits, or "COB" savings) did not constitute estimated salvage recoverable for purposes of the 87% special deduction rule.

c. No expense is allowable under section 832(b)(6) as an "expense incurred" unless that expense is allowed as a deduction by section 832(c).

(1) Allowable deductions include ordinary and necessary business expenses, interest, taxes, losses, etc. See Home Group, Inc. v. Comm'r, 89-1 U.S.T.C.¶9329 (2d Cir. 1989).

(2) Capital losses from investment assets sold to obtain funds to pay abnormal insurance losses or policyholder dividends are deductible from ordinary income. Section 832(c)(5).

(3) Policyholder dividends paid by mutual P&C insurers to policyholders are fully deductible. Section 832(c)(11). The 1986 Act states that this provision is to be studied by the Treasury Department. 1986 Act Bluebook at 621.

E. See Example #22, infra.

V. Blue Cross and Blue Shield Organizations

A. Under pre-1986 Act law, the "Blues" were exempt from Federal income tax.

B. In general, the 1986 Act provides that for years after 1986 the Blues will be taxable as stock P&C insurance companies. Sections 501(m), and 833(a)(1) and (c).

C. However, the section 832(b)(4) provision requiring a 20-percent reduction of the unearned premium reserve deduction does not apply to the Blues. Section 833(a)(3).

D. Moreover, the Blues are allowed a special deduction. Section 833(a)(2) & (b). The deduction equals the excess of 25% of claims and expenses for the year over adjusted surplus at the beginning of the year. In calculating claims incurred and expenses incurred, the Blues include claims and expenses incurred under cost-plus contracts. Section 833(b)(1). 1997 Blue Book at 486.

E. Similar organizations also qualify. Section 833(c)(4).

F. Upon conversion to taxable status, the Blues were allowed to take a fair market value basis in their assets. 1986 Act § 1012(c)(3)(A)(ii). Some Blues began treating certain intangible assets, e.g., customer lists, provider networks, and workforce in place, as separate assets and have claimed losses upon the termination of those customer, provider, and employee contracts.

G. In Notice 2000-34, 2000-33 I.R.B. 1 (July 26, 2000), the IRS announced that it will challenge deductions claimed by Blue Cross Blue Shield organizations for termination of customer, provider, and employee contracts.

1. In Trigon Insurance Co. v. U.S., 215 F. Supp.2d 687 (E.D.Va. 2002), the court held that a Blue Cross/Blue Shield organization was not entitle to a tax refund arising in connection with the abandonment of appraised, intangible assets consisting of terminated health insurance subscriber and provider contracts. While the "fresh start" basis rule applied to allow a basis step-up for the contracts, the valuation conducted by the taxpayer's expert of the fair market value of the subscriber and provider contracts was neither accurate nor reliable. Accordingly, the taxpayer failed to establish by a preponderance of the evidence that it had overpaid its taxes. See also Capital Blue Cross v. Comm'r, 431 F. 3d 117 (3d. Cir. 2005) (held that a Blue Cross and Blue Shield organization could deduct losses related to the termination of customer insurance contracts in an amount to be determined on remand of the case to the Tax Court).

2. In Highmark, Inc. v. U.S., 78 Fed. Cl. 146 (2007), the court held that a Blue Shield organization was entitled to claim refunds for tax overpayments and interest based on loss deductions for terminated and cancelled health insurance coverage contracts. Because the health care contracts produced value and could be transferred for consideration, they were assets covered by the "fresh start rule." The court found that the fresh start rule applied to any losses, including those arising from termination or cancellation of the organization's contracts. See also Hospital Services Ass'n v. U.S., 78 Fed. Cl. 434 (2007) (the "fresh start rule" applied to loss deductions claimed by a Blue Cross/Blue Shield organization on termination of its health insurance coverage contracts that were in place when it was a tax-exempt entity).

TAXATION OF LIFE INSURANCE COMPANIES

I. General Considerations

A. Types of organizations - Life insurers are chartered under state law as stock or mutual companies.

B. Economic Functions

1. Underwriting -- Issuance of life insurance, accident and health insurance, and annuity contracts.

2. Investment -- Investing primarily in bonds, stock, mortgages, and real estate.

3. Insurers act as an intermediary spread risk among insureds. With numerous insureds, under the law of large numbers, events become actuarially predictable.

II. Major Tax Concepts

A. In general, life insurance contracts entail long-term obligations and liabilities. Life insurance reserves reflect the long-term nature of those insurance risks. Life insurance companies are those insurance companies that issue such contracts and hold such reserves.

B. Life Insurance and Other Types of Contracts

1. Life insurance contracts

Life insurance contracts insure life contingencies. There are different types of life insurance contracts, including whole life and term contracts. Life insurance contracts must satisfy the test set forth in section 7702.

2. Annuity contracts

Annuity contracts provide for a series of payments at fixed intervals.

3. Noncancellable A&H contracts ("noncan A&H")

A&H contracts pay benefits for sickness or accidental injury or death. To be considered noncancellable, the issuing company must be obligated to renew the contract at a specified premium through the insured's 60th birthday. In addition, the company must hold both an unearned premium reserve and an "additional reserve" for the policy.

4. Guaranteed renewable A&H contracts

   To be guaranteed renewable, a contract must not be cancelable by the Company, but the Company may retain the right to adjust premium rates by classes to reflect its experience. In addition, the Company must hold both an unearned premium reserve and an "additional reserve" for the policy.

C. Life Insurance Company

1. To qualify as a "life insurance company," a company must be an "insurance company." An insurance company is a company more than one half of the business of which is issuing insurance or annuity contracts, or reinsuring risks underwritten by other insurance companies. Section 816(a). See Rev. Rul. 83-132, 1983-2 C. B. 270 (an entity need not be organized as a corporation to be taxed as an insurance company).

2. Moreover, the company must be engaged in the business of issuing certain types of insurance contracts (section 816(a)):

   a. Life insurance contracts

   b. Annuity contracts

   c. Noncancelable health and accident contracts ("noncan A&H")

   d. Guaranteed renewable health and accident contracts (section 816(e))

3. Finally, more than 50 percent of the company's "total reserves" must consist of (a) "life insurance reserves," and (b) unearned premiums and unpaid losses on noncan or guaranteed renewable A&H policies (to the extent not included in life insurance reserves). Section 816(a).

4. "Life insurance reserves" are defined in the Code as amounts (section 816(b)):

   a. computed or estimated on the basis of recognized tables and assumed rates of interest,

   b. set aside to liquidate future unaccrued claims arising from life insurance, annuity, and noncan A&H contracts which involve life or A&H contingencies,

   c. required by law.

D. <u>The Theory of Life Insurance Reserves</u>

1. Under life insurance contracts companies are obligated to pay, in the future, benefits to policyholders. Companies establish reserves in order to reflect their (unaccrued) liability to pay those benefits.

2. Many life insurance policies involve long-term risks. In order to provide for those risks, an insurer must hold reserves greater than the unearned premium reserve.

3. The cost of life insurance increases with age. Level premium whole life insurance policies charge premiums in excess of early year mortality cost. That excess is accumulated for later years, when mortality costs exceed the amounts of premiums paid. Thus, the function of reserves is to balance timing differences between premiums and mortality cost.

4. Under the mean reserve method, the mean life insurance reserve as of the December 31, 1989 valuation date is as follows:

$$\frac{\text{Reserve at 6-30-1989} + \text{Reserve at 6-30-1990}}{2} + \frac{\text{Annual Premium}}{2}$$

5. Viewed retrospectively, the total reserve for life insurance policies equals the total of premiums paid, plus interest thereon, less benefits already paid.

6. Viewed prospectively, the total reserve for life policies equals the present value of future benefits less the present value of future premiums. <u>See</u> Example #22.

7. All states follow the prospective view, which is embodied in the Standard Valuation Law.

E. <u>Life Insurance Premiums</u>

1. Gross premiums are comprised of the net valuation portion and the loading portion.

2. The net valuation portion is the amount designed to provide all benefits under the contract. In the aggregate, net premiums are sufficient, based on assumed rates of mortality and interest, to pay all death claims as they become due.

3. Upon issuance of a policy, the present value of benefits to be provided must equal the present value of premiums to be paid. The timing of benefit payments is determined by use of a mortality table. Those benefit payments are brought to present value by use of an assumed interest rate. This produces a hypothetical single net premium. Using the same

mortality table and interest rate, that single premium is projected into annual net level premiums.

4. The balance of the gross premium, or loading, covers expenses and profit.

F. Valuation Methods

1. There are two basic valuation methods; the net level method and the preliminary term method.

2. Under the net level method, the net premium added to the reserve in each year remains constant.

3. The loading element of the first year premium typically is insufficient to cover expenses (e,g., the first year agent commission). Thus, the required reserve is established out of the company's surplus.

4. To avoid this result, the preliminary term method may be used on the annual statement. Under this method, the first year reserve, and the first year net premium are reduced. Net premiums and reserve additions are increased in later years to make up the difference.

G. Mortality Tables

Mortality tables are used to predict mortality, and are used in reserve and premium calculations.

H. Assumed Rates of Interest

An insurance company must estimate the interest that it can earn on reserves. The higher the rate of interest assumed, the lower the reserves required. Conservative rates of interest are assumed.

I. Other elements, too complex to be discussed here, also enter into the reserve computations.

III. Taxation Under the 1959 Act: 1958 to 1981 (Historical Background)

A. Overall Framework

1. Under former section 802(b), "life insurance company taxable income" (LICTI) generally equaled:

a. The lesser of "taxable investment income" (TII) and "gain from operations" (GFO), plus

b. If GFO exceeded TII, 50 percent of that excess.

2. Taxable investment income represented income from investment operations. Any excess of gain from operations over TII represented income from underwriting operations.

3. Under section 802, a life insurance company's income was taxed in three "phases:"

   a. Phase I - current taxation of investment income (TII),

   b. Phase II - current taxation of one-half of underwriting income (1/2 excess of GFO over TII),

   c. Phase III - deferred taxation of one-half of underwriting income.

4. The deferred one-half of underwriting income was credited to the "policyholders surplus account" (section 815). In general, amounts in this account were taxed only when distributed to shareholders, such as when a company was acquired and liquidated.

B. <u>Taxable Investment Income</u>

1. Generally, TII was computed as follows:

   a. Gross income from investments,

   b. Less: investment and similar expenses,

   c. Exclude: the amount of net investment income credited to reserves or paid as interest (the policyholders, share of investment yield),

   d. Plus: long term capital gains,

   e. Minus: certain specified deductions.

2. Thus, the policyholder's share of each item of investment yield was excluded from the Phase I tax base.

   a. This accomplished the goal of not taxing the company on the portion of investment income that was, in effect, credited to reserves.

   b. The "proration" of interest and the dividends received deduction between the company's share and the policyholders' share achieved the goal of preventing the funding of reserves with tax-exempt income.

C. <u>Gain (or Loss) from Operations</u>

1. Generally, GFO was computed as follows:

a. Gross income from all sources, including investment income, premiums, and net capital gains,

b. Exclude: the amount of net investment income credited to reserves (the policyholders' share of investment yield),

c. Less: deductions peculiar to the insurance business,

d. Less: general corporate deductions,

e. Less: special insurance deductions, subject to a limitation based on TII.

2. In the computation of gain from operations, a limitation was imposed on three special deductions, the principal one being the deduction for policyholder dividends.

   a. The limitation that was imposed equaled the excess of GFO (computed without the special deductions) over TII, plus $250,000 (former section 809(f)).

   b. As a result, most mutual companies were taxed on GFO exactly equal to TII less $250,000.

   c. This limitation served two purposes. First, it ensured that companies were taxed, at least, on most of their investment income. Additionally, it reflected the view that some portion of policyholder dividends should be nondeductible and thus taxed at the company level (as are dividends of stock companies).

   d. Second, the limitation was intended to allocate the insurance industry tax burden between the stock companies and the mutual companies (31% to stock companies and 69% to mutual companies).

D. Problems Under the 1959 Act

1. In the early 1980s, Congress determined that the 1959 Act had failed to respond to changes in the economic environment (inflation, rising interest rates, and new types of insurance products) and that, as a result, companies were resorting to newly developed tax-avoidance techniques (in particular, the use by mutuals of modified coinsurance).

2. Modified coinsurance (MODCO) was a type of reinsurance whereby risks, assets and reserves were deemed transferred to the reinsurers and premium income was deemed received by the reinsurers. Under these arrangements, the reinsured did not receive investment income (taxable in TII), but rather experience refunds (taxable in GFO).

IV. Taxation During the EFRA Stopgap: 1982 And 1983 (Historical Background)

A. In TEFRA, Congress enacted temporary measures, effective for the years 1982 and 1983 -- the so-called "stop-gap period."

B. Former section 820, governing MODCO, was permanently repealed. However, MODCO contracts for years before 1982 were grandfathered.

C. The former section 809(f) limitation on special deductions was made more liberal. The prior $250,000 figure was increased to $1 million. In addition, an alternative limitation was provided, allowing mutuals to deduct 77-1/2 percent of their policyholder dividends.

D. TEFRA made other significant changes as well.

E. As a result of TEFRA, many mutual companies changed from Phase I to Phase II (Negative) taxpayers. Thus, for these years, audits and controversies in respect of mutual companies shifted from the TII arena to the GFO arena.

V. Taxation Under the 1984 Act: 1984 and on

A. In drafting the 1984 Act, Congress stated that it had two motives: to create a statutory scheme better adapted to current economic conditions, and to create a simplified taxing structure.

B. In General

1. Structure of the 1984 Act

a. The 1984 Act imposes a "single phase" tax base, based on a stock company model.

b. The 1984 Act was designed to impose a certain aggregate tax burden on the life insurance industry and, for 1984, to allocate that tax burden between the mutual segment (55%) and the stock segment (45%) of the industry.

2. Many concepts and elements are carried over from the 1959 Act to the 1984 Act. For example, the requirements for qualification as a life insurance company, while revised, are basically the same.

C. Tax is Imposed on LICTI

1. Section 801(a)(1) imposes a tax on LICTI. Section 801(a)(2) imposes an alternative tax for companies with net capital gain.

2. LICTI is defined as "life insurance gross income" reduced by "life insurance deductions." Section 801(b).

3. In addition, in some cases, a tax will be imposed with respect to distributions from the pre-1984 Phase III account. Section 801(c) and 815. The Seventh Circuit recently decided a case involving a distribution from a company's policyholders surplus account, and held that the fair market value (and not the adjusted basis) of real property distributed is the amount subject to the "Phase III" tax. Bankers Life & Casualty Co. v. U.S., 98-1 U.S.T.C. ¶50,346 (7th Cir. 1998). The 2004 Jobs Act suspended the Phase III tax for tax years 2005 and 2006.

D. Life Insurance Gross Income

1. Under the 1984 Act, all of a company's gross income is included in its tax base. Section 803.

2. Premiums are included in income, less return premiums and indemnity reinsurance premiums paid. Section 803(a)(1). See Rev. Rul. 94-45, 1994-2 C.B. 39 (the reinsurance of policies from parent to subsidiary is a section 351 transaction, so that a transfer of assets is not taxable as premium income).

   a. Under minimum premium plans, a supplemental premium is due if and when the plan terminates. Must the supplemental premium be accrued prior to plan termination? Massachusetts Mutual Life Ins. Co. v. U.S., 66 Fed. Cl. 217 (Fed. Cl. 2005).

3. Decreases in reserves are included in income. Section 803(a)(2) and 807(a).

   a. In the computation of GFO under prior law -- former section 809(a) and 810(a) -- the amount of the decrease in reserves did not reflect the policyholders' share of investment income. The reason was that the policyholders' share was excluded from gross income.

   b. Under the 1984 Act, the full amount of investment income, including the policyholders' share of investment income, is included in income. Thus, the full decrease in reserves is reflected in income.

   c. As will be described later, the amount of the decrease in reserves is increased by the policyholders' share of tax-exempt interest, and may be increased by a "section 809" amount for tax years beginning before 2001. Section 807(a)(2)(B), 809, and 812. (Section 205 of the Pension Equity Funding Act of 2004, Pub. L. No. 108-218, permanently repealed section 809 effective beginning in 2005).

4. Gross income includes all other amounts, including the total amount of investment income (but not tax-exempt interest). Section 803(a)(3).

E. Life Insurance Deductions

1. Section 804 provides that life insurance deductions include:

    a. The "small life insurance company deduction," provided by section 806, and the

    b. "General deductions," specified in section 805.

2. As originally enacted, section 804 also provided for a "special life insurance company deduction," which was computed under section 806.

    a. The "special" deduction was equal to 20 percent of the excess of tentative LICTI over the "small company" deduction. It was intended to provide relief from the increased tax burden imposed by the 1984 Act.

    b. In the 1986 Act, Congress determined that this relief was no longer necessary, and repealed the deduction.

F. Small Life Insurance Company Deduction

1. The small company deduction is equal to 60 percent of tentative LICTI up to $3,000,000. Section 806.

    a. The deduction phases out by 15 percent of tentative LICTI over $3,000,000. Thus, for companies with tentative LICTI over $15,000,000 the deduction is zero.

    b. The deduction is not allowed to any company with assets over $500 million.

2. "Tentative LICTI" is defined as LICTI determined without the small company deduction, and excluding all items attributable to a "noninsurance business." Thus, the small company deduction is allowable only against insurance income.

G. General Deductions

1. The general deductions are specified in section 805. These deductions are somewhat similar to the deductions in former section 809(d).

2. Claims and benefits accrued, and losses incurred, are deductible. Section 805(a)(1).

3. The increase in reserves is deductible. Section 805(a)(2) and 807(b).

    a. The full amount of the increase, without any reduction for the policyholders' share of investment income, is reflected.

b. Under prior law, a portion of tax-exempt interest was excluded from income as the policyholders' share of investment income. In theory, a portion of the interest credited to reserves was deemed to be tax-exempt interest.

c. Under the 1984 Act, the same result is accomplished by a different method. The amount of the increase in reserves deductible from income is reduced by the policyholders' share of tax-exempt interest. Section 807(b)(1)(B) and 812.

4. Policyholder dividends are deductible. Section 805(a)(3) and 808.

a. The definition of policyholder dividends

(1) Under the 1959 Act, the deduction for policyholder dividends was limited, while the deduction of return premiums and interest paid was not. Problems arose regarding experience rated refunds and excess interest.

(2) The 1984 Act broadly defines policyholder dividends to include all such amounts. Section 808(b).

b. The timing of the dividends deduction

(1) Under the 1959 Act, dividends were accounted for on a reserve basis (a deduction was allowed for liability to pay dividends, even if unaccrued).

(2) Under the 1984 Act, dividends are deductible only to the extent "paid or accrued." Section 808(c)(1).

(a) Accrued dividend deductions are allowable for policyholder dividends guaranteed to be paid to post-1983 policyholders in the year following adoption of board resolutions containing the guarantee. All events fixing liability occurred in the year the guarantee was adopted. Further, the dividends qualified as "rebates or refunds" for purposes of the recurring item exception to the economic performance rule. The economic substance doctrine does not apply in this context. Massachusetts Mutual Life Ins. Co. v. U.S., 109 AFTR 2012-837 (Fed. Cl. 2012).

(b) In New York Life Insurance Co. v. U.S., 2011-1 U.S.T.C. ¶ 50373 (S.D.N.Y. 2011), the court held that the Taxpayer may not accrue and deduct in the taxable year either (a) annual dividends on an insurance policy that accrue in the taxable year and, under the terms of the policy, become payable during the first month of the succeeding taxable year, or (b) the lessor of the termination dividend or the annual dividend. The court reasoned that the all events test was not satisfied.

(c) In TAM 200948042, the IRS held that a Taxpayer may not accrue and deduct in the taxable year annual dividends on an insurance policy that, under the terms of the policy, become payable during the first month of the succeeding taxable year.

(d) Also in TAM 200948042, the IRS held that a Taxpayer may not accrue and deduct in the taxable year the lesser of (1) the termination dividend that will be payable in the succeeding taxable year if the policy is terminated, or (2) the annual dividend that will be payable in the succeeding taxable year if the policy is not terminated.

(3) Normally, this change from the reserve to the accrual method would be a change in method of accounting, and section 481 would apply. However, the 1984 Act gives the dividend reserves a "fresh start." Thus, no section 481 adjustment must be made.

(4) A question exists regarding the amount of the "fresh start" that applies to companies that have accrued policyholder dividends. <u>See</u> LTR 9224001 (Feb. 12, 1992).

(a) In <u>National Life Ins. Co. v. Comm'r</u>, the Tax Court and the Second Circuit held that such a company must create a year-end 1983 accrual balance. 103 T.C. No. 615 (1994), <u>aff'd</u>, 103 F.3d 5 (2d Cir. 1996).

(b) As a result, companies with accrued dividends receive less "fresh start" than other companies.

(5) The "fresh start" is taken away to the extent that a company changes its policyholder dividend practices in order to "accelerate" its dividend deductions. Section 808(f).

c. When a mutual company demutualizes, it may distribute cash and stock to policyholders. It has been held that such distributions are not policyholder dividends. <u>UNUM Life Ins. Co. v. U.S.</u>, 929 F. Supp. 15 (D. Me. 1996), <u>aff'd</u>, 130 F.3d 501 (1st Cir. 1997).

The court held that the term "dividend" does not include a distribution to an equity owner in exchange for the equity ownership.

d. In certain cases, the policyholder dividend deduction of mutual companies will be reduced for tax years beginning before 2001. Section 808(c)(2). This will be discussed, infra.

5. A deduction is allowed for dividends received from other corporations. Section 805(a)(4).

a. Generally, only the "company's share" of the dividends received deduction is allowed. Sections 805(a)(4)(A)(ii) and 812.

b. However, "100 percent dividends" (for example, from a wholly-owned subsidiary) are deductible in full, except to the extent distributed out of tax-exempt income of the subsidiary or the increase in policy cash values of life insurance, annuity, or endowment contracts owned by the distributing corporation to which section 264(f) applies.

6. All other deductions allowed under the Code, subject to some modifications, are allowable to life insurance companies. Section 805(a) and (b).

H. Proration under the 1984 Act

1. Under the 1959 Act, the policyholders' share of investment income was excluded from both the Phase I and Phase II tax bases. Then, only the company's share of tax-exempt interest and the dividends received deduction were deducted.

2. As discussed above, the 1984 Act prorates these items differently:

a. Tax-exempt interest is totally excluded from a company's gross income. However, the policyholders' share of tax-exempt interest then reduces the deduction for reserve increases (or increases the income from reserve decreases).

b. As discussed above, a company may deduct only the company's share of the dividends received deduction.

c. See Example # 24, infra.

3. The 1984 Act's proration formula, which is stated in section 812, is similar to the prior law's Phase II proration formula (required interest over investment yield).

a. "Required interest" under Section 812(b)(2)(A) is determined by using mean of amount of reserve at beginning of tax year and amount of reserve at end of tax year. Section 812(b)(2) provided no guidance on method of calculating interest, and legislative history indicated that formula used for this purpose was based on proration formula used under prior law in computing gain or loss from operations. Rev. Rul. 2003-120.

b. The "company's share" is (1) the company's share of net investment income over (2) net investment income. Section 812(a)(1).

c. Gross investment income, defined in section 812(d), is similar to the old law's Phase I definition.

d. Net investment income is 90 percent of gross investment income. Section 812(c).

e. The company's share of net investment income is the excess of net investment income over the sum of:

(1) Policy interest, consisting of required interest, and portions of excess interest and other interest, and

(2) A portion of policyholder dividends.

4. The IRS created a safe harbor for taxpayers who would otherwise have to take into account portion of yearly increase in policy cash values on "I-COLI" contracts. As long as contracts cover no more than 35% of total aggregate number of individuals described in Code Sec. 264(f)(4)(A) at any time during tax year, insurance cos. won't be required to take increases into account under proration rules in Code §§ 805, 807, and 812. Rev. Proc. 2007-61.

5. <u>See</u> Example #25, <u>infra</u>.

I. <u>Reserves under the 1984 Act</u>

1. Under the 1959 Act, reserves were utilized in both Phase I and Phase II. In Phase I, they entered into the formula for excluding the policyholders' share of investment income. In Phase II, they played a similar role, and they also determined the amount of expense (or income) due to the increase (or decrease) in reserves allocable to premium income.

2. Under the 1984 Act, reserve increases (or decreases) allocable to both premiums and investment income constitute an expense (or income). As noted above, closing reserve balances are reduced by the policyholders' share of tax-exempt interest.

3. As under the 1959 Act, the "items taken into account" for these purposes include not only "life insurance reserves," but also unearned premiums, unpaid losses, etc. Section 807(c).

4. Under the 1959 Act, life insurance reserves were the amounts reflected on a company's NAIC annual statement. However, preliminary term reserves could be revalued on the net level basis for tax purposes. Former section 818(c).

5. For purposes of qualification as a life insurance company under section 816, annual statement reserve amounts are still utilized. Section 807(d)(1).

6. However, for purposes of computing LICTI, two changes are made:

    a. Section 818(c) revaluations are no longer available, and

    b. Specially computed tax reserves, rather than annual statement reserve amounts, must be used to compute LICTI.

7. In computing LICTI, the amount of life insurance reserves for a contract is the greater of (1) net surrender value, and (2) the federally prescribed reserve. Section 807(d)(1).

8. However, the amount of the reserves so determined cannot exceed the amount of the annual statement statutory reserves. This is referred to as the annual statement "cap."

    a. What rules, if any, govern how reserves on the annual statement must be computed in order to qualify as "statutory reserves"?

    b. In situations where a life insurance company does business in several states with different minimum reserve requirements, the end-of-year Code § 807(d)(6) statutory reserve is the highest aggregate reserve amount for Code § 807(c) items actually held and set forth on annual statement under state reserve requirements in *any* state in which the company does business. Under different facts presented, although company actually holds highest aggregate minimum reserves required by any state and either reports this figure to each state ins. regulator on its annual NAIC statement, to avoid state-by-state variations, or reports only minimum reserves required by that particular state to each state, lower minimum requirements of some states have no effect on determination of statutory reserves under Code § 807(d)(6). Rev. Rul. 2008-37.

9. IRS issued interim guidance for situations involving variable annuity contract to which recently adopted actuarial guideline applies. Guidance

addressed reserve ratio test, statutory reserve cap, federally-prescribed reserve, ten-year spread, and standard scenario amount. Notice 2010-29.

10. Net surrender value is determined with regard to surrender charges, but without regard to policy loans. Section 807(e)(1).

11. Annuity reserves are determined under CARVM, which determines the future value of guaranteed benefits at future year ends. If surrender charges are waived at each year end, those charges are not taken into account and do not reduce reserves. LTR 9452001 (Aug. 26, 1994).

12. Under pension deposit contracts, the reserve is the policyholders' fund reduced by surrender charges. LTR 9452001 (Aug. 26, 1994).

13. Federally prescribed reserves are computed using (section 807(d)(2)):

    a. A specified reserve method (Various preliminary term methods are specified. E.g., for life insurance, CRVM must be used).

    b. The greater of a prevailing State assumed interest rate and an AFR rate,

    c. Prevailing State mortality or morbidity tables.

14. Insurers must use the reserve method prescribed by the NAIC that is in effect on the date of the issuance of the contract. The question arises whether a subsequently issued Actuarial Guideline creates a new reserve method or merely serves as a guide to applying an existing reserve method. A court has held that issuance of Actuarial Guideline 33 does not create a new CARVM. The court limited its holding to Actuarial Guideline 33. American Financial Group v. U.S., 109 AFRT 2d 2012-2034 (6th Cir. 2012).

15. See Treas. Reg. § 1.807-1 for a list of "prevailing" rates and tables. See also Rev. Rul. 92-19, 1992-1 C. B. 227, which has been supplemented by annual revenue rulings, including Rev. Rul. 2012-6.

    a. Section 807 requires that taxpayers use CARVM prescribed by the NAIC as of the date of issuance. If the NAIC is silent on the CARVM issue, taxpayers must use the prevailing state practice. LTR 200448046 (Aug. 30, 2004).

16. A company may elect to recompute reserves every five years using the then-current interest rate. Once the election is made, the company must continue it. Section 807(d)(4)(A)(ii).

17. These new rules, which generally will result in smaller reserves, must be used in 1984 and subsequent years. Closing 1983 reserves will be

computed under old law, and closing 1984 reserves under new law. Thus, in 1984 a large decrease in reserves could result. To prevent recognition of a section 481 income adjustment, the 1984 Act gives reserves a "fresh start."

18. Certain special reserves for supplemental benefits are excluded from these rules. Section 807(e)(3).

    a. For these reserves, annual statement amounts are allowable.

    b. If the reserve is for a "qualified" supplemental benefit, the reserve is computed as if the benefit were provided under a separate contract. LTR 9620001 (Jan. 23, 1996).

    c. To be "qualified," there must be a separately identified premium or charge for the benefit. LTR 9442001 (June 7, 1994).

19. Certain special reserves for substandard risks also are excluded from the generally applicable reserve rules. Section 807(e)(5).

20. A question exists regarding the extent to which the new rules prescribed in section 807 apply not only to life insurance reserves, but also to other section 807(c) reserve items.

21. Under the case law, reserves that are not actuarially computed do not qualify as "life insurance reserves" for tax purposes. Companies, by varying their methods of computing reserves, could choose to be taxed as a P&C or as a life company. Prop. Treas. Reg. § 1.801-4(g) permits the IRS to recompute reserves on an actuarial basis and have them qualify as life insurance reserves.

22. If a company changes its method of computing reserves, the change may qualify as a "change in basis." Section 807(f). The IRS' consent is not required and the resulting change in reserves is taken into account ratably over 10 years. Rev. Rul. 94-74, 1994-2 C.B. 157, which distinguishes between a change in basis and the correction of an error, takes the position that most changes are changes in basis and that a change only rarely should be treated as the correction of an error. See also, Rev. Rul. 2002-6, 2002-6 I.R.B. 460 (concluding that a change in reserve computations to conform to NAIC guidelines was a change in basis for purposes of section 807(f)).

23. Questions will arise as insurance regulators require that reserves be computed in ways that are different from the way that section 807 requires reserve computations. These new methods produce what are called "principle-based reserves." See Notice 2008-18.

a. In 2009 the NAIC adopted changes to the Standard Valuation Law conditionally approving principle-based reserves.

J. The Section 809 Add-on Tax

1. Congress has always believed that some portion of the policyholder dividends paid by mutual companies represents a distribution of earnings. Such a distribution ordinarily is not deductible.

2. In the 1959 Act, section 809(f) imposed a limitation on the deduction of policyholder dividends.

3. The 1984 Act imposed the section 809 add-on tax to accomplish two goals:

   a. To tax to mutual companies the amount of income deemed to be distributed to policyholders as earnings. The amount of such earnings is estimated on the basis of a hypothetical return on equity. The rate of return is determined by reference to the earnings rates of stock companies.

   b. To achieve "segment balance" between stock and mutual life insurance companies. The initial earnings rate was set to allocate 55 percent of the 1984 industry tax burden to mutuals.

4. Section 611(a) of the Job Creation and Worker Assistance Act of 2002, P.L. No. 107-147, suspended the operation of section 809 for tax years beginning in 2001, 2002, and 2003. Section 809(j). See Notice 2002-33, 2002-21 I.R.B. 989 (announcing that life insurance companies are not obligated to file Form 8390 in 2002 or 2003). Section 205 of the Pension Funding Equity Act of 2004, Pub. L. No. 108-218, repealed section 809 for tax years beginning on or after January 1, 2005.

5. The amount of income "added on" to the taxable income of mutuals is termed the "differential earnings amount" (DEA). Section 809(a).

   a. First, the DEA reduces the policyholder dividends deduction. Sections 808(c) and 809(a)(1).

   b. If there is any excess DEA, it reduces the closing balance of reserves. Sections 807(a) and (b) and 809(a)(2).

6. The DEA is the product of a company's "average equity base" times the industry's "differential earnings rate." Section 809(a)(3).

7. A company's average equity base is the mean of its opening and closing equity base for the year.

a. A company's equity base is its surplus and capital per its annual statement, increased by various amounts, such as:

(1) nonadmitted financial assets,

(2) the excess of annual statement reserves over tax reserves,

(3) certain other reserves (e.g., voluntary reserves, and the mandatory security valuation reserve),

(4) 50 percent of the provision for policyholder dividends.

b. The mandatory security valuation reserve no longer appears on the annual statement -- it was replaced by two reserves, the asset valuation reserve (AVR) and the interest maintenance reserve (IMR). Treas. Reg. § 1.809-10 provides that the AVR and the IMR must be included in the equity base.

c. If a company reduces its equity base, it reduces its DEA and its add-on tax.

8. The differential earnings rate (DER) is the excess of an "imputed earnings rate" over an "average mutual earnings rate."

9. The imputed earnings rate is a stock company earnings rate determined as the numerical average of the earnings rates of the 50 largest stock companies.

a. For 1984, Congress set the imputed earnings rate at 16.5 percent in order to achieve a segment balance imposing 55 percent of the industry tax burden on mutual companies.

b. In subsequent years, changes in the imputed earnings rate, which reflect current stock earnings rates, are indexed to the 16.5 percent rate.

10. The average mutual earnings rate is the weighted average of mutual company earnings to their average equity bases.

11. The average mutual earnings rate applied to compute the DEA is the rate for the second preceding year. In the following year, the DEA is recomputed using a recomputed average mutual earnings rate. Section 809(f).

a. Any increase or decrease in the DEA is taken into account as income or as a deduction in the recomputation year.

b. This process is referred to as a "true-up" or a "true-down."

12. The appropriateness of allowing a "negative" differential earnings rate was advocated by taxpayers and contested by the IRS. See IRS Notice 88-106, 1988-2 C.B. 444; Rev. Rul. 89-106,1989-2 C. B. 108.

    a. American Mutual Life Ins. Co. v. U.S. held that the negative RDER is not allowed. 43 F.3d 1172 (8th Cir. 1994), cert. denied, 516 U.S. 930 (1995).

    b. In Indianapolis Life Ins. Co. v. U.S., 115 F.3d 430 (7th Cir. 1997), the Seventh Circuit upheld the validity of the same Treasury regulation that was at issue in American Mutual. See also, CUNA Mutual Life Ins. Co. v. U.S., 97-2 U.S.T.C. ¶50,904 (Fed. Cl. 1997).

    c. In John Hancock Financial Services, Inc. v. U.S., 2003-2 U.S.T.C. ¶50,595 (Fed. Cl.), aff'd, 378 F.3d 1302 (Fed. Cir. 2004), the Court rejected the taxpayer's argument, which was based on the tax benefit rule, that it should not be required to reduce its policyholder dividends deduction for 1988 and 1989.

13. The section 809 add-on mechanism has several unusual consequences:

    a. It attempts to allocate a total industry tax burden between stock and mutual companies (segment balance).

    b. It determines the tax burden imposed on mutuals as a group by reference to the earnings rates of stocks (coupling).

    c. It determines the tax imposed on each mutual company by reference to the earnings of other mutuals (socialization).

14. Most mutuals considered and/or implemented alternatives that enabled them to avoid section 809 add-on taxes prospectively.

    a. One way to avoid section 809 was to demutualize, i.e., to become a stock company.

    b. It was also possible to rearrange under a mutual holding company provision, such that the mutual company becomes a stock company. See LTR 9745013 (Aug. 7, 1997)(conversion of mutual life insurance company to stock life insurance company using a mutual holding company form is a tax-free reorganization under §§ 351 and 368(a)(1)(E)).

    c. A life insurance company that was organized in stock form but later underwent a "mutualization" under state law, filed suit claiming that it is not a mutual company, but a stock or nonmutual company not subject to section 809. The basis of the company's claim was that it issues a significant amount of non-participating insurance and thus lacks the "mutuality" necessary to be a mutual. The court held that the company was a mutual life insurance company, because it had no stockholders and was owned by the policyholders during the years at issue in the case. Pan American Life Ins. Co. v. U.S., 97-2 U.S.T.C. ¶50,655 (E.D. La. 1997).

K. Deferred Acquisition Costs (DAC)

1. The 1990 Act enacted Code section 848, which provides for the capitalization and amortization of "specified policy acquisition expenses."

2. Congress declined to measure actual acquisition costs. Instead, section 848(c)(1) uses specified percentages of "net premiums" as a proxy in the computation of specified policy acquisition expenses.

   a. The DAC rules substitute for the ordinary capitalization rules, which therefore do not apply. LTR 200334005 (April 16, 2003).

3. Net Premiums

   a. Only premiums on "specified insurance contracts" are subject to DAC. Treas. Reg. § 1.848-1(b).

      (1) Included are life insurance, annuity, and noncancelable or guaranteed renewable A&H contracts.

      (2) Certain insurance contracts are excluded, such as pension plan contracts, flight insurance, and medical savings account contracts.

   b. Net premiums are calculated as gross premiums received, less return premiums and reinsurance premiums paid.

   c. Section 848(d)(3) excludes various phantom premiums from net premiums.

   d. If a policy is exchanged for another policy, the value of the policy may be included in net premiums. Certain internal exchanges of insurance policies are excluded from this treatment. Treas. Reg. § 1.848-2; LTR 9623005 (Feb 22, 1996).

4. The percentage applied to net premiums varies depending on the type of specified insurance contract.

   a. The percentage for annuities is 1.75%.

b. The percentage for group life insurance contracts is 2.05%. To narrow the contracts eligible for this category, the regulations strictly define what is a "group" contract. Treas. Reg. § 1.848-1(h).

c. The percentage for all other specified insurance contracts is 7.7%.

d. Under combination contracts (providing more than one type of coverage), separately stated premiums are allocated between the coverages provided. If not separately stated, the highest capitalization percentage applies. Treas. Reg. § 1.848-1(g).

5. In general, section 848(a)(2) provides for ratable amortization over a 120 month period. Section 848(b) provides a special rule (60 months) for small companies. Section 848(j) provides a transitional rule for the year 1990.

6. The case law had established that ceding commissions paid by the reinsurer on reinsurance contracts must be capitalized and amortized over the life of the reinsured policies. Section 848(g) provides that such ceding commissions are no longer subject to that case law, but must be amortized under the rules specified in section 848.

7. In the case of reinsurance, section 848(d)(4) prohibits the deduction of reinsurance premiums in computing net premiums if the reinsurance premiums are paid to a reinsurer not subject to U.S. taxation. A special mechanism is provided so that such a foreign reinsurance transaction can be treated separately and thus not subjected to a double DAC tax. Treas. Reg. § 1.848-2(h)(3).

8. In a reinsurance transaction, net premiums are determined by aggregating all amounts of consideration passed between the parties to the reinsurance agreement. Treas. Reg. § 1.848-2(f).

9. Expenditures incurred for the development of new insurance products, including expenditures for overhead, actuarial services, product registration, legal and professional expenses, educational/training expenses, are not subject to capitalization under section 263, because application of section 848 generally trumps section 263. LTR 200334005 (April 16, 2003).

10. <u>See</u> Example #26.

L. <u>Reallocation of Reinsurance Transactions</u>

1. The IRS can propose adjustments to tax items attributable to a reinsurance agreement between <u>related</u> parties if the IRS determines that the reallocation is necessary to reflect the proper amount, source or character

of taxable income. Section 845(a) (as amended by section 803 of the 2004 Jobs Act).

2. The IRS also can propose adjustments to tax items attributable to a reinsurance agreement between unrelated parties, but only if necessary to correct a "significant tax avoidance effect." Section 845(b).

3. In Trans City Life Ins. Co. v. Comm'r, the Tax Court held that two unrelated parties had substantial business purposes for their reinsurance agreement and that there was no substantial tax avoidance effect. 106 T.C. 274 (1996), nonacq., 1998-1 I.R.B. 5.

TAXATION OF INSURANCE PRODUCTS

I. Taxation of Life Insurance Policies

A. Types of Life Insurance

1. Term insurance

Term life insurance furnishes a specific quantity of insurance protection for a specific period of time. The face amount of the policy is paid if death occurs during the term; otherwise, nothing is paid. Premiums increase with the age of the insured, reflecting greater insurance risk.

2. Traditional whole life insurance

Whole life insurance typically is in force for the insured's lifetime. Premiums usually are "level." In early years, the premiums have an investment element, which is the excess over the current cost of insurance protection. In later years, the cost of insurance protection exceeds current premiums, and is paid out of the investment element. A whole life policy may be "paid-up" at a specified point. Such a policy may be a "single premium" policy.

3. Universal life insurance

Universal life insurance is similar to whole life insurance except that the amount and timing of premiums, and the amount of the death benefit, are flexible. Generally, these contracts enable a rapid accumulation of cash value.

4. Endowment life insurance

An endowment policy provides insurance protection for a term of years, and then, if the insured is still alive at the end of the term, pays the face amount to the policyholder.

B. Qualification as "Life Insurance"

1. As mentioned above, whole life insurance contains an insurance element and a savings or investment element.

2. Interest credited as the investment element of insurance policies is not currently taxed to policyholders (the so-called "inside buildup"). Some policies may be considered investment-oriented, in that they provide for the accumulation of large, tax-free investment elements.

3. TEFRA, for the years 1982 and 1983, enacted temporary guidelines for determining if contracts qualify as life insurance contracts for purposes of excluding death benefits from income. Section 101(f).

4. The 1984 Act provides a definition of the term "life insurance contract" for tax purposes. <u>See</u> section 7702. The definition contains two alternative tests.

5. The first test is the "cash value accumulation test"

   a. This test must be met by the terms of the contract.

   b. Under the test, the cash surrender value must not exceed, at any time, the single premium required to purchase the benefits offered, at that time, by the contract.

   c. In other words, the investment element of the contract cannot be excessive vis-a-vis the insurance protection provided. Whole life insurance contracts with "reasonable" interest rates will qualify under this test.

6. The second test imposes "guideline premium" and "cash value corridor" requirements.

   a. This test has two parts. The test is a practical one that must be met at all times.

   b. Under the "guideline premium" part of the test, the sum of all premiums paid as of any date cannot exceed an amount necessary to fund future benefits. This test ensures that the policyholder does not make premium payments in excess of amounts necessary to pay for the insurance protection provided.

   c. Under the "cash value corridor" part of the test, the policy's death benefit must be within an applicable percentage of the cash surrender value. For example, for a 55-year old policyholder a policy with a $10,000 cash value must provide a death benefit of at least $15,000. This test ensures that an excessive investment element does not accumulate.

7. If a policy does not meet the definition of life insurance, the policy is treated as a combination of term insurance and a taxable deposit. Section 7702(g).

   a. Thus, income on the policy is currently taxed to the policyholder. The income equals the increase in cash value, plus the cost of insurance provided, less premiums paid.

b. Moreover, only the excess of the death benefit over the cash value is eligible for exclusion from the income of the beneficiary.

c. Nevertheless, the contract will continue to be treated as a life insurance contract for life insurance company tax purposes.

d. The IRS may "waive" the failure to meet the tests of section 7702 if it was due to reasonable error and reasonable steps were taken to correct the error. LTR 9601039 (Oct. 5, 1995); LTR 9517042 (Jan. 31, 1995); LTR 9524021 (Mar. 21, 1995); LTR 9322023 (Mar. 9, 1993); LTR 9202008 (Oct. 31, 1991).

8. Section 7702 applies to contracts issued after 1984. Contracts issued in exchange for existing contracts after 1984 may be subject to the new definition.

C. <u>Premiums Paid for Life Insurance</u>

1. Premiums paid by individuals for life insurance or annuities are, in general, nondeductible personal expenditures. Section 262.

2. An employer that pays life insurance premiums, in order to supplement an employee's income, generally may deduct the premium payments as a business expense. Section 162.

3. However, if the employer is the beneficiary of a life insurance policy on an officer or employee, the employer generally may not deduct premiums paid with respect to that policy. Section 264(a)(1).

4. Thus, premiums are not deductible on life insurance which names an employer corporation as the beneficiary and which is used:

a. to fund a buy-sell agreement providing for the redemption of the employee's stock in the employer corporation at the time of the employee's death.

b. to secure a loan to the employer.

5. An employee may have to report an employer's premium payments as compensation income. Section 62.

6. However, if an employer provides group-term life insurance, employees can exclude from income a portion of the premiums paid by the employer. Employees must include in income only the cost of group-term insurance coverage that is in excess of the sum of (1) the cost of $50,000 of insurance coverage plus (2) any amount of the cost paid by the employee. Section 79(a). <u>See</u> Example #27.

a. No amount is included in the employee's income if the employer or a charity is the beneficiary. Section 79(b)(2).

b. The rule applies to both active and retired employees. However, no amount is included in the income of terminated disabled employees. Section 79(b)(1).

c. If the group-term insurance plan discriminates in favor of key employees (active or retired), such key employees do not get the income exclusion.

D. <u>Interest Paid in Connection with Life Insurance</u>

1. Subject to the "modified endowment contract" rules discussed below, a policyholder may receive a loan of the cash value held with respect to a life insurance policy. If the loan is outstanding at death, the loan reduces the amount of the death benefit paid.

2. Most interest on policy loans on life insurance policies of individuals will be nondeductible under the "personal interest" rules of section 163(h). If the loan is taken for investment purposes, the investment interest rules apply. Section 163(d).

3. No interest is deductible on indebtedness incurred to purchase or carry single-premium policies. Section 264(a)(2). Such policies include policies on which substantially all of the premiums are paid within 4 years of the date of purchase. Section 264(c).

4. In general, no interest is deductible on indebtedness to purchase or carry any life insurance policy, if the plan of purchase contemplates systematic borrowing of increases in cash value. Section 264(a)(3).

   a. Limited safe harbor rules are provided Section 264(d).

   b. A safe harbor is provided if 4 out of the first 7 annual premiums are not borrowed. Section 264(d)(1). <u>But</u> <u>see</u>, TAM 200213010 (Dec. 11, 2001) (concluding that policy loan interest was non-deductible by a corporate taxpayer despite the fact that premiums were paid without loans in four of the first seven policy years).

5. If an employer owns a life insurance policy covering the life of an employee, the issue is whether the employer may deduct interest on indebtedness with respect to the policy.

   a. Formerly (through 1995), an employer could deduct interest on indebtedness with respect to a "key employee" up to $50,000 of borrowing. Prior section 264(a)(4).

b. Some companies began large case COLI programs, insuring thousands of employees, and borrowing $50,000 on each policy. Interest credited inside the contracts (say 9%) was less than the interest paid on the borrowing (say 11%). However, because the interest paid was deductible, the after-tax interest rate (say 8%) created a positive return on the COLI program.

c. In the 1996 Act, the interest deduction was generally repealed for interest paid after 1995. Section 264(a)(4). In a 1998 Technical Advice Memorandum, however, the IRS disallowed a company's interest deductions in connection with COLI policies for years prior to 1996. LTR 9812005 (Jan. 22, 1998). A number of companies have contested the IRS position outlined in the TAM.

(1) In Winn-Dixie Stores, Inc. v. Commissioner, 113 T. C. 254, aff'd, 254 F.3d 1313 (11th Cir.), cert. denied, 122 S. Ct. 1537 (2002), the Tax Court and the Third Circuit ruled in favor of the IRS and held that the COLI program at issue lacked economic substance and, thus, disallowed the taxpayer's policy loan interest deductions.

(2) In Internal Revenue Service v. CM Holdings, 254 B.R. 578 (D. Del.), aff'd, 301 F.3d 96 (3d Cir. 2002), the United States District Court in Delaware and the Third Circuit also held in favor of the IRS.

(3) In American Electric Power Co. , Inc. v. United States, 136 F. Supp.2d 762, aff'd, 326 F.3d 737 (6th Cir. 2003), cert. denied, 124 S. Ct. 1043 (Jan. 12, 2004), the court again held in favor of the IRS. The taxpayer has filed a petition for a writ of certiorari.

(4) In the most recently litigated leveraged COLI case, the taxpayer prevailed at the trial level. Dow Chemical Co. and Subsidiaries v. United States, 250 F. Supp.2d 748 (E.D. Mich. 2003). On appeal, the Sixth Circuit reversed in favor of the government (1/23/2006).

(5) Another COLI case, Ameritech, was filed in the Tax Court in December of 2000 and settled in September of 2003.

d. The deduction is retained for insurance on up to 20 "key persons," who are either officers or 20-percent owners of the employer. However, the amount of interest deductible cannot exceed that credited at specified rates. Section 264(e)(2) and (e)(4).

e. Various phase-in and grandfather rules apply to existing indebtedness.

f. Employers may seek to terminate the life insurance, since it produces a negative return without the tax deduction. Under a relief provision, income on such a termination can be brought into income ratably over 4 years.

g. For life insurance policies and annuity and endowment contracts issued after June 8, 1997 to other than natural persons, an interest expense disallowance rule applies to the portion of a taxpayer's interest expense "allocable to unborrowed policy cash values. " Section 264(f).

   (1) A contract's "unborrowed policy cash value" equals the cash surrender value (disregarding any surrender charge) of the contract, less the amount of any loan with respect to such contract.

   (2) The amount of interest expense "allocable to" the unborrowed policy cash values, for which a deduction is disallowed, is calculated as follows:

   aggregate amount of allowable interest expense without regard to sections 264(f), 265(b) and 291,

   <u>multiplied by</u>:

   taxpayer's average unborrowed policy cash values for contracts issued after June 8, 1997, <u>over</u> the sum of (1) the taxpayer's average unborrowed policy cash values for all contracts, and (2) the average adjusted bases of all other assets of the taxpayer.

   Section 264(f)(2).

   (3) Exceptions to the pro rata interest disallowance rule are provided. Section 264(f)(4) and (f)(5). Importantly, one exception covers certain policies owned by an employer on the lives of its employees, officers and directors.

E. <u>Interest Earned in Connection with Life Insurance</u>

1. As stated above, the investment element of qualifying life insurance is not currently taxed to the policyholder.

2. However, if the Section 7702 definition of life insurance is not met, the investment income is taxed to the policyholder.

3. The tax-free "inside buildup" is the subject of current legislative options.

F. <u>Withdrawals of Cash Value</u>

1. Except in the case of a "modified endowment contract," a policyholder that withdraws funds (prior to the death of the insured) from the cash value of a life insurance policy first recovers the "investment in the contract," and then the investment earnings. Section 72(e)(5)(C). Withdrawals of the investment in the contract are not includible in income, whereas withdrawals of investment earnings are.

2. The investment in the contract is the sum of premiums and other consideration paid, minus the aggregate amount received under the contract prior to the withdrawal that was not subject to tax. Section 72(e)(6).

3. However, if there is a distribution during the first 15 years of the contract due to a decrease in future benefits, the distribution will be considered first out of investment earnings, and includible in the income of the policyholder to that extent. Section 7702(f)(7).

4. Moreover, the investment-first ordering rule does not apply in the case of "modified endowment contracts. "

   a. Modified endowment contracts are defined as contracts entered into after June 20, 1988, that fail to meet a 7-pay test. Section 7702A. A contract fails the 7-pay test if the total of premiums paid for the contract at any time during the first 7 years exceeds the sum of the net level premiums that would have been paid by that date if the contract provided for paid-up future benefits after the payment of 7 level annual premiums.

   b. In the case of such contracts, distributions are treated first as distributions of income on the contract, and loans are treated as distributions. Section 72(e)(10). Such distributions are subject to a 10 percent additional tax. Section 72(v).

c. The IRS has provided a procedure for correcting certain "inadvertent, non-egregious" failures to meet the 7-pay test. Rev. Proc. 2001-42, 2001-36 I.R.B. 212.

5. <u>See</u> Example #28.

G. <u>Receipt of Death Benefits</u>

1. Amounts paid under a life insurance policy by reason of the death of the insured generally are not includible in income. Section 101(a). Thus, the "inside buildup" escapes income taxation.

2. However, if the recipient of the death benefits has purchased the policy for value, then the benefits generally are taxable to the extent that they exceed the amount paid for the policy plus any premiums subsequently paid. Section 101(a)(2).

3. There are two exceptions to this transfer-for-value rule (section 101(a)(2)(A)&(B)):

   a. If the transferee's basis is determined by reference to the transferor's basis (<u>e.g.</u>, a gift).

   b. Transfers to the insured, a partner of the insured, or the insured's partnership or corporation (<u>e.g.</u>, buy-sell contracts).

4. If death benefits are held by the insurance company and paid at a later date with interest, the exclusion for death benefits applies only to the principal and not to the interest. A prorated amount of each payment is considered to be a part of death benefits and is excluded from income. The remainder is included in income. Section 101(d). <u>See</u> Example #29.

5. Note that the section 101 income exclusion applies in full to post 1984 contracts only if they constitute life insurance as defined by section 7702. There is a similar rule applicable to universal life insurance issued before January 1, 1985. <u>See</u> section 101(f).

6. Accelerated Death Benefits

   a. Under section 101(a), to be excluded from income, life insurance benefits must be paid by reason of the death of the insured. Life insurance benefits paid to someone terminally ill would not qualify for exclusion.

   b. The IRS proposed regulations that would have allowed such benefits to qualify.

c. The 1996 Act enacted section 101(g), under which payments of death benefits to terminally ill and chronically ill persons are deemed paid by reason of death.

d. Payments of death benefits include the proceeds of sales to viatical settlement providers. Section 101(g)(2).

e. Terminally ill persons are those expected to die within 24 months. Section 7702(g)(4)(A). Chronically ill persons are those with restricted ability to care for themselves. Section 7702B(c)(2).

f. Benefits received by chronically ill persons are excludible only up to specified limits. Section 101(g)(3).

g. The exclusion does not apply to benefits paid to an employer with respect to a terminally ill or chronically ill employee. Section 101(g)(5).

H. Split Dollar Contract Arrangements

1. There are several variations of these plans, under which the employer and the employee share the benefits payable, and may share the premiums due, under the life insurance contract.

2. For years prior to 2002:

a. The employee is taxed on the value of the economic benefit received from the employer's participation in the arrangement, as measured by the cost of insurance protection provided. Rev. Rul. 64-328, 1964-2 C.B. 11 (applying one-year premium rates ("P.S. 58" rates) set forth in Rev. Rul. 55-747); Rev. Rul. 67-154, 1967-1 C.B. 11; Rev. Rul. 66-110, 1966-1 C.B. 12. Such benefits also include any policyholder dividends. LTR 9604001 (Sept. 8, 1995).

b. The employer may not deduct its portion of the premium. Section 264(a)(1); Rev. Rul. 64-328, supra.

c. The death benefits received by the employer and the employee are excludible under section 101.

3. In Notice 2001-10, 2001-5 I. R. B. 459, the IRS revoked Rev. Rul. 55-747 (and, implicitly, Rev. Rul. 64-238) and issued interim guidance regarding the tax treatment of split-dollar arrangements. Notice 2001-10 set forth a new table of one-year term insurance premium rates to be used in lieu of the P.S. 58 rates for determining the current value of life insurance protection under split dollar arrangements for tax years

ending after January 31, 2001. The Service received many unfavorable comments from tax practitioners regarding this Notice.

4. In Notice 2002-8, 2002-4 I.R.B. 398, the IRS revoked Notice 2001-10 and announced that it would issue propose regulations that would govern the taxation of split-dollar arrangements using one of two mutually exclusive regimes -- the economic benefit regime or the loan regime. Notice 2002-8 also provided interim guidance for split-dollar arrangements.

5. In Notice 2002-59, 2002-36 I.R.B. 481, the IRS targeted certain split dollar arrangements where the donor retains current insurance protection as "understating the value" of policy benefits conferred and distorting the income, employment, and gift tax consequences of such arrangements. For such arrangements, the table set forth in Notice 2002-10 or the insurer's published premium rates (if lower) may not be used to value the policy benefits conferred upon the donee.

6. Final split dollar regulations implementing the economic benefit and loan regimes were published on September 17, 2003, and made effective as of that date. See Treas. Reg. §§ 1. 61-22; 1. 7872 15. The regulations apply to split dollar arrangements between employers and employees, donors and donees, service providers and recipients of services (independent contractors), and corporations and shareholders.

    a. The economic benefit regime applies to life insurance contracts where the employer is the owner of the contract.

        (1) Under this regime, the employee must report compensation income each year equal to the sum of (1) the cost of current life insurance protection provided to the employee, (2) the amount of policy cash value to which the employee has current access (to the extent not taken into account in a prior taxable year), and (3) any other economic benefits not taken into account in a prior taxable year. Treas. Reg. § 1.61-22(d)(2).

        (2) Death benefits paid to the employee's beneficiary are excludible under section 101 (a) only to the extent that the employee paid the cost of such insurance, or the employee took the value of current life insurance into income as described above.

    b. The loan regime applies to life insurance contracts where the employee is the owner of the contract.

        (1) Under this regime, the employer is treated as the lender, and the employee is treated as the borrower, of amounts

paid directly or indirectly by the employer pursuant to the split dollar arrangement if three conditions are satisfied: (1) a payment (including a premium payment) is made by the employer to the employee; (2) the payment is a loan under general principles of Federal tax law, or a reasonable person would expect repayment in full; and (3) the repayment is to be made from, or is secured by, the policy's death benefit proceeds, the cash surrender value, or both. Treas. Reg. § 1.7872-15(a)(2).

(2) Interest income may be imputed (if the split dollar loan is a "below market" loan). OED rules may apply.

7. The IRS has challenged "charitable" split dollar arrangements. See, e.g., Addis v. Commissioner, 2004-2 U. S. T. C. ¶50,291 (9th Cir.) (Disallowing charitable deduction with respect to charitable split dollar arrangement).

II. Long Term Care Insurance Contracts

A. The 1996 Act provides rules for insurance contracts that cover long-term care services, which are services provided to a chronically ill person by a qualified provider. Section 7702B.

B. To be qualified, the contract must be guaranteed renewable, not provide a cash surrender value, and not cover expenses reimbursable under Medicare. Section 7702B(b).

C. A qualified long-term care insurance contract is treated as an A&H contract. Section 7702B(a).

1. For the policyholder, amounts received as benefits are treated as received for personal injuries and sickness and are excluded from income under section 104, up to a specified limit ($175 per day, or $63,875 annually, indexed in accordance with section 213(d)(10)).

2. For the insurer, the contract is treated as an A&H contract.

D. If the covered individual buys the coverage, the premiums paid are considered medical expenses that are deductible subject to the section 213(d)(10) limitation and the overall AGI limitation of section 213(a). See also, Rev. Proc. 2001-13, 2001-3 I.R.B. 337. (The premiums are partially deductible by self-employed individuals through 2002, and fully deductible thereafter.) The benefits received by the employee are excluded from income subject to the specified limit.

E. If an employer provides the coverage, the employer can deduct the premiums, the premiums are not income to the employee (unless provided through a cafeteria plan or FSA), and benefits received by the employee are excluded from income subject to the specified limit.

F. Benefit payments in excess of the specified limit are excludible only to the extent of actual costs. Amounts in excess of actual costs constitute income.

G. Unreimbursed long-term care expenses are treated as medical expenses (subject to the AGI limitation of section 213(a)).

III. Taxation of Annuity Policies

A. Annuities

1. In general, annuities are contracts under which an insurance company, for consideration, agrees to make specified payments either for a fixed period or for a designated lifetime. Most annuities contain a refund feature, which provides that, in any event, a minimum amount will be paid.

2. Consideration is paid during the accumulation phase of the contract. At the annuity starting date, the pay-out phase of the contract begins.

B. Interest Paid in Connection with Annuities

1. The section 264 interest rules discussed above also apply to annuities. Rev. Rul. 95-53, 1995-2 C.B. 30 (if an annuity is pledged to obtain a mortgage loan, an allocable portion of the interest paid on the mortgage loan is not deductible).

2. Amounts borrowed from annuity contracts are not treated as loans, but as withdrawals (see discussion infra).

C. Interest Earned in Connection with Annuities

1. In general, annuity holders are not taxed on the "inside buildup" of investment income.

2. However, if the annuity holder is a nonnatural person (e.g., a corporation) the contract is not treated as an annuity for tax purposes and the income on the contract is currently taxable. Section 72(u). Some exceptions are provided (e.g., annuities held under a qualified plan). LTR 9322011 (Mar. 5, 1993); LTR 9316018 (Jan. 22, 1993); 9120024 (Feb. 20, 1991) (the nominal owner of the annuity can be a nonnatural person, as long as the beneficial owner is a natural person).

D. Withdrawals Before the Annuity Starting Date

1. Section 72(e) provides rules applicable to withdrawals prior to the annuity starting date.[11]

   a. As to annuities issued after August 1982, withdrawals are treated as first out of investment income, to the extent thereof, and then out of the investment in the contract ("LIFO").

   b. As to annuities issued before August 1982, the new rule applies to investments in those annuities made after that date. (Thus, income on pre-August 1982 investment is grandfathered.)

   c. Moreover, a penalty generally is imposed on such withdrawals, equal to 5 percent of the amount includible in income, but only if the withdrawal was of income allocable to an investment made within the prior 10-year period. Section 72(q). Certain withdrawals are excepted from penalty (e.g., withdrawals after age 59-1/2).

2. Post-1984 Act annuities

   a. As to contracts issued after January 1985, the penalty applies even as to withdrawals of investments made within the prior 10-year period.

   b. Moreover, such contracts must contain distribution-at-death rules similar to those imposed in respect of IRAs. Section 72(s).

3. The 1986 Act increased the 5-percent early withdrawal penalty to 10 percent.

4. An exchange of annuities may result in the loss of favorable grandfather treatment.

E. Receipt of Annuity Payments

[11] Section 72(e) was amended by TEFRA, with respect to contracts issued after August 1982 and with respect to investments in any existing contract made after August 1982; again by the 1984 Act, with respect to contracts issued after January 1985; and again by the 1986 Act.

Pre-TEFRA annuities: Like the general rule for life insurance, withdrawals were treated as first out of the investment in the contract, and then out of investment earnings ("FIFO").

1. Amounts paid under an annuity contract after the annuity starting date consist of two elements: non-taxable return of investment, and taxable investment earnings.

2. The non-taxable portion is spread over the annuity period or annuitant's life expectancy by means of an "exclusion ratio" formula.

3. The "exclusion ratio" is the "investment in the contract" divided by the "expected return" under the contract as of the annuity starting date. Section 72(b)(1).

    a. The investment in the contract is the sum of premiums and considerations paid, less any amounts received before the annuity starting date and not included in income. Section 72(c)(1).

    b. If the annuity contains a refund feature, the value of that feature as of the annuity starting date is subtracted from the investment in the contract. Section 72(c)(2).

    c. The expected return is the sum of the payments due over either a period certain or the annuitant's life expectancy, as the contract provides. Section 72(c)(3).

4. Each annuity payment is multiplied by the exclusion ratio: the result is excluded from income, the remainder is included in income.

5. <u>See</u> Examples #30, 31, and 32.

6. Any withdrawal after the annuity starting date is includible in income in full. Section 72(e)(2)(A). Thus, the investment in the contract and the exclusion ratio are not recomputed.

7. In the case of long-lived annuitants, the amount excluded from income cannot exceed the investment in the contract. Section 72(b)(2).

8. In the case of short-lived annuitants, the amount of the unrecovered investment in the contract is allowed as a deduction to the annuitant for his last taxable year. Section 72(b)(3).

IV. <u>Variable Contracts</u>

A. "Fixed" contracts accumulate investment earnings at a fixed rate specified in advance. Variable contracts invest in segregated assets, which are accounted for separately from the insurance company's general assets, and accumulate whatever earnings are attributable to those segregated assets.

B. Variable contracts are defined as (section 817(d)) --

1. Contracts that are backed by a segregated asset account (or separate account).

2. Contracts that are annuities, life insurance, or group term life or A&H insurance on retired lives.

3. Contracts under which the amounts paid in or out, or the benefits, reflect the investment return and market value of the segregated asset account.

C. The reserve for the contract equals the value of the assets in the account. However, for purposes of computing the increase or decrease in reserves --

1. Amounts added to reserves to reflect appreciation in value (realized or unrealized) are subtracted.

2. Amounts subtracted from reserves to reflect depreciation in value (realized or unrealized) are added back. Section 817(a).

D. Correspondingly, the basis of assets in the account are increased to reflect appreciation and decreased to reflect depreciation.

E. A variable contract will not be treated as an annuity or life insurance contract if the assets in the segregated account are not adequately diversified. Section 817(h).

1. The purpose is to avoid use of these products primarily to shield the investment income of specifically targeted investments.

2. Several diversification standards and a safe-harbor rule are provided. Treas. Reg. §1.817-5(b) & (f).

3. There are "look through" rules that allow the segregated account to invest in regulated investment companies, and to be treated as if the account held the assets of the RIC. Rev. Rul. 2005-7. Rev. Rul. 2007-58.

4. If the diversification standards are not met, the income on the contract is currently taxed to the policyholder. Treas. Reg. § 1. 817-5(a). Compare Rev. Rul 2003-91, 2003-33 I. R.B. 347 (variable life insurance and annuity contract holders not treated as owners of contracts because interests in sub-accounts of separate accounts are not available for sale to the public) and Rev. Rul. 2003-92, 2003-33 I.R.B. 350 (variable life insurance and annuity contract holders treated as owners of partnership interests funding a variable contract because partnership interests available for purchase by the general public). See also LTR 200244001 (May 2, 2002) (concluding that certain variable life insurance contracts did not meet the diversification standards

where interests in private investment partnerships and money market funds backing the subaccounts of the segregated asset account were available to the "general public," with the result that contract holders were treated as the owners of these investments and, thus, had to report gains and losses on the investments). See Rev. Rul. 2007-7, amplifying and clarifying Rev. Rul. 81-225, 1981-2 CB 12 and Rev. Rul. 2003-92, 2003-2 CB 350.

5. Notice 2000-9, 2000-1 C. B. 449, provides relief for certain contracts that fail to meet the diversification standards.

6. Notice 2008-92, 2008-43 I.R.B. 1001, provides relief for money market funds participating in the Temporary Guarantee Program, which is provided by the Treasury Department in response to the credit market instability to make available certain funds from its Exchange Stabilization Fund to certain money market funds. The Notice provides that for purposes of determining whether a segregated asset account is adequately diversified, each United States government agency or instrumentality is treated as a separate issuer.

F. The IRS has ruled that only cash, and not assets, may be transferred from the general account to the separate account. Rev. Rul. 73-67, 1973-1 C.B. 330. However, this ruling was revoked in 1997. Rev. Rul. 97-46, 1997 46 I.R.B. 7. As a result, a life insurance company may transfer assets other than cash to a segregated asset account for qualified pension plans.

V. Modified Guaranteed Contracts

A. Modified guarantee contracts are variable-like contracts that do not qualify as variable contracts under section 817 because they provide for a guaranteed interest rate for some period of time.

B. In the 1996 Act, section 817A was enacted to accord special treatment to these contracts.

C. To qualify, assets under the contract must be held in a separate account, and the reserves for the contract must be valued at market value. Section 817A(d)

D. Assets in the separate account are marked-to-market. Thus, each year the assets are treated as if sold, and any gain or loss is taken into account as ordinary income or loss. Section 817A(a). (Any such gain or loss is excluded when the asset ultimately is sold.)

E. Mark-to-market gains and losses offset reserve increases and decreases each year. In contrast, under section 817, there is no gain or loss recognized and no reserve increase or decrease is taken into account. Thus, sections 817 and 817A achieve similar net results with different adjustment methods.

VI. Partial Annuitization Rules

A. Section 72(a)(2) allows holders of annuities to elect to receive a portion of an annuity contract in the form of a stream of annuity payments, leaving the remainder of the contract to accumulate income on a tax-deferred basis.

B. The holder of the annuity must receive amounts as an annuity for a period of 10 years or more or during one or more lives under any portion of an annuity, endowment, or life insurance contract.

1. That that portion will be treated as a separate contract for annuity taxation purposes.

2. For purposes of applying section 72(b) (dealing with the calculation of the exclusion ratio for annuity distributions), section 72(c) (definitions of "investment in the contract," "expected return," and "annuity starting date"), and section72(e) (dealing with the taxation of distributions from an annuity, endowment, or life insurance contract, that are not received as an annuity), the investment in the contract will be allocated pro rata between each portion of the contract from which amounts are received as an annuity, and the portion of the contract from which amounts are *not* received as an annuity.

3. In addition, a separate annuity starting date under section 72(c)(4) (which defines "annuity starting date") will be determined for each portion of the contract from which amounts are received as an annuity.

VII. Tax-Free Exchanges of Policies

A. Hypothetical situation

A taxpayer, age 29, obtains a whole life insurance policy to ensure income for surviving family. At age 59, that taxpayer is more concerned about retirement income.

B. Taxable solution

The taxpayer can surrender the life insurance policy, but any amount received in excess of the investment in the contract is includible in income. Section 61, 1001. The after-tax proceeds can be used to purchase the annuity.

C. Non-taxable solution

Exchange the life insurance policy for the annuity policy, tax-free, under section 1035. A 1998 Administration proposal was introduced that would change this treatment for exchanges involving variable contracts.

D. Qualifying exchanges

1. A life insurance contract may be exchanged for a:

   a. life insurance contract,

   b. endowment contract, or

   c. annuity contract.

2. An endowment contract may be exchanged for an:

   a. endowment contract, or

   b. annuity contract.

3. An annuity contract may be exchanged for an annuity contract.

4. The IRS has ruled that the exchange of two flexible premium life insurance contracts for one variable deferred annuity contract constitutes a tax-free exchange under section 1035. LTR 9708016 (Nov. 20, 1996). See also, Rev. Rul. 2002-75, 2002-45 I. R.B. 812 (consolidation of two annuity contracts issued by different insurers); LTR 200243047 (July 30, 2002) (one annuity contract exchanged for two annuity contracts); LTR 9644016 (July 18, 1996) (same).

5. Exchanges involving less than 100% of the policy owner's interest in an annuity contract may also qualify for tax-free treatment. See Conway v. Commissioner, 111 T.C. 350 (1998), acq., 1999-47 I.R.B. 573; Rev. Rul. 2003-76, 2003-33 I.R.B. 355.

E. Exchange Procedures

1. With life insurance policies, the insured under the old and new policies must be the same. With annuities, the contracts must be payable to the same person. See Rev. Rul. 90-109, 1990-2 C.B. 191. LTR 9542037 (July 21, 1995) (exchanges of single-insured policies for a second-to-die policy are taxable).

2. The old and new policies may be issued by different insurers. Rev. Rul. 72-358, 1972-2 C.B. 473.

3. The old policy should be assigned to the insurer of the new policy. Care must be taken not to "cash out" and thereby trigger taxable income. LTR 8310033 (Dec. 3, 1982).

F. Tax Results

1. No gain or loss is recognized on the exchange.

2. If "boot" is received, the rules of section 1031 apply, and gain is recognized to the extent of the fair market value of the boot.

3. The basis of the new policy is equal to the basis of the old policy, (1) less cash received, (2) less any loss recognized, (3) plus any gain recognized.

4. See Example #33.

G. Cautions

Pre-TEFRA and Pre-1984 Act annuities and life insurance contracts have grandfathered status. An exchange of such a policy for a new policy may, or may not, cause loss of favorable grandfather status. Rev. Rul. 85-159, 1985-2 C.B. 29.

H. In response to recent insolvencies of insurance companies, the IRS has issued rulings allowing for exchanges of policies issued by troubled insurers. See Rev. Rul. 92-43, 1992-1 C.B. 288; Rev. Proc. 92-44 (as amended by 92-44A, 1992-1 C.B. 875.

OTHER INSURANCE TOPICS

I. Self Insurance

A. Types of deductions allowed

1. Insurance premiums paid for property and casualty insurance are deductible if they are an ordinary and necessary expense incurred in a trade or business. Treas. Reg. § 1.162-1(a).

2. Losses compensated for by such insurance are not deductible. Treas. Reg. § 1.165-1(a).

3. Losses and payments made with respect to uninsured liabilities are deductible if incurred in connection with a trade or business. Section 165(a).

B. Timing of deductions

1. Controversies have arisen concerning the timing of deductions for amounts "credited" to "reserves" for self-insurance.

a. P&C insurers can hold reserve liabilities for "unpaid losses," including estimated losses incurred and resisted claims.

b. Treas. Reg. § 1.461-1(a)(2), applicable to non-insurance taxpayers, provides that an expense is accruable and may be deducted when all events have occurred that determine the fact of liability and the amount thereof can be determined with reasonable accuracy. See also section 461(h)(4).

c. In general, a taxpayer cannot accrue a deduction based upon a prediction that liability ultimately might be established. In other words, additions to a liability reserve for estimated losses are not deductible. E.g., Supermarkets General Corp. v. U.S., 537 F. Supp. 759 (D.N.J. 1982).

d. However, liability triggered by an event and imposed by law can be considered fixed under the all events test. E.g., Kaiser Steel Corp. v. U.S., 717 F.2d 1304 (9th Cir. 1983) (workmen's compensation); U.S. v. Hughes Properties, Inc., 476 U.S. 593 (1986).

e. Similarly, liability imposed by contract can be considered fixed under the all events test. E.g., Lukens Steel Co. v. Comm'r, 442 F.2d 1131 (3d Cir. 1971).

f. However, the Supreme Court has held that the all events test does not go so far as to allow ordinary taxpayers to mirror the treatment accorded to P&C insurers. General Dynamics Corp. v. U.S., 6 Cl. Ct. 250 (1984), aff'd, 773 F.2d 1224 (Fed. Cir. 1985), rev'd, 87-1 U.S.T.C. ¶ 9280 (U.S. 1987).

2. Accrual method taxpayers are now subject to the "economic performance" test of section 461(h).

   a. In the case of workmen's compensation and tort liabilities, this generally means that no deduction is allowed until actual payments are made to third parties. Section 461(h)(2)(C).

   b. Section 461(h)(3) provides a "recurring item" exception to the economic performance requirement.

   c. However, the recurring item exception does not apply to workmen's compensation and tort liabilities. Section 461(h)(3)(C).

   d. The purpose of the economic performance requirement is to reflect the time value of money. Note that the method of "discounting" the liabilities of ordinary taxpayers differs from the method of "discounting" unpaid loss reserves of P&C insurers.

3. A deduction may be allowable for payments with respect to "contested liabilities" pursuant to section 461(f).

   a. In general, if a taxpayer contests a liability, then that liability cannot be accrued under the all events test.

   b. However, if the taxpayer transfers money or property beyond his control -- for example, to an escrow agent -- in satisfaction of the contested liability, then a deduction may be allowable in the year of the transfer. Although, in the case of workers, compensation and tort liabilities, the deduction is not allowed until payments are made to the claimant. Section 461(f)(4).

4. Often, the issue presented is whether the taxpayer has "paid" an insurance "premium."

   a. A "payment" to the taxpayer's segregated bank account does not qualify.

   b. Likewise, a "payment" to an agent does not qualify. Spring Canyon Coal Co. v. Comm'r, 43 F.2d 78 (10th Cir. 1930), cert. denied, 284 U.S. 654 (1930).

c. As discussed below, payments of "premiums" to captive insurance companies may not qualify.

d. Even premium payments to an insurance company will not qualify if the arrangement is not insurance. Steere Tank Lines, Inc. v. U.S., 577 F.2d 279 (5th Cir. 1978), cert. denied, 440 U.S. 946 (1979).

5. Similar issues arise in connection with retrospectively rated insurance contracts.

a. The IRS may challenge a retrospectively rated insurance arrangement as not being true "insurance." See LTR 8637003 (May 23, 1986); LTR 8638003 (June 11, 1986).

b. This issue is likely to receive additional attention by the IRS in the future.

6. "After-loss" insurance presents similar issues. See Rev. Rul. 89-96,19892 C.B. 114; FSA 200209017 (Nov. 26, 2001) (recommending application of principles of Rev. Rul. 89-96 to situation where employer that was self-insured for 22 years obtained insurance potentially covering residual losses from the past 22 years); GCM 39795 (Apr. 15, 1982); GCM 35796 (May 1, 1974). Rev. Rul. 2007-47 (arrangement that pre-funds future obligations is not insurance for tax purposes).

7. The IRS may raise other arguments in order to defeat the current deductibility of premiums.

a. In Black Hills Corp. v. Comm'r, 73 F.3d 799 (8th Cir. 1996), an industry captive issued black lung coverage to its owner/policyholders. Premiums were payable currently (thus building up a reserve, which was refundable in certain circumstances), while claims for benefits were not expected until future dates.

b. Under INDOPCO, the court held that the premium payments must be capitalized.

II. Captive Insurance Companies

A. Captive insurance companies may be formed for a variety of reasons

1. Nontax motives

a. To obtain insurance at lower cost

b. To insure risks that are uninsurable in conventional insurance markets.

2. Tax motive

The primary tax motive is to obtain a current deduction for "premiums" paid to the captive.

B. Captives generally take one of two forms

1. Direct-writing captives

These captives issue policies to the insured and receive premiums from the insured.

2. Reinsurer captives

These captives assume business written by a direct writer, which is often referred to as the "fronting" company. See, e.g., Kidde Industries Inc. v. U.S., 98-1 U.S.T.C. ¶50,162 (Fed. Cl. 1998) (parent company could deduct the amount of premium payments made to third-party insurer that were not ceded back to the company's wholly-owned captive insurance company).

C. IRS Treatment of Captive Issues

1. The IRS treats captive insurance arrangements as a coordinated issue. The IRS has approved settlement guidelines with respect to captives. See, "IRS Updates ISP Settlement Guideline List," 2001 Tax Notes Today 190-18 (Sept. 27, 2001).

2. On December 10, 2002, the IRS issued Rev. Proc. 2002-75, 200252 I.R.B. 997, which revokes the IRS's previous "no ruling" policy regarding captive arrangements (see sections 4.01(11) and 4.01(41) of Rev. Proc. 2002-3, 2001-1 I.R.B. 117). The IRS will now consider ruling requests regarding the proper tax treatment of a captive insurance company.

D. The Captive Must Be an "Insurance Company"

1. The captive must be operating as an insurance company, rather than as some other type of company, such as an investment company.

2. For example, see LTR 200453012 (Sept. 15, 2004).

E. Shifting of Risk Between Parent and Subsidiary Captive

1. The IRS views captive insurance arrangements not as actual insurance, but as no more than a form of self-insurance. The captive is considered an incorporated self-insurance reserve.

2. The result is the same whether the captive is the direct writer or the ultimate reinsurer.

3. Until recently, the IRS took the position that for a captive insurance arrangement to be respected, there must be a shifting of risk away from the "economic family." If the risk merely was shifted within an economic family -- for example, from a parent to a subsidiary - then the IRS argued that no economic shifting of risk had occurred and no "insurance" existed. See, e.g., Rev. Rul. 77-316, 1977-2 C.B. 53; Rev. Rul. 88-72, 1988-2 C.B. 31.

4. In such a case, while the parent has shifted the responsibility for paying the loss to its subsidiary, the parent's investment in the subsidiary declines in value when the subsidiary pays the loss. Under this "balance sheet" analysis, there is no shifting of the risk.

5. Under the IRS's position, "premiums" paid are not deductible. Those payments are treated as capital contributions to the captive. "Benefits" paid by the captive are dividends to the extent of the captives earnings and profits. The parent is entitled to deduct its losses, which are not compensated for by "insurance." Since there is no insurance, the captive cannot be taxed as an insurance company.

6. In the context of parent/subsidiary captive arrangements, where no insurance is issued to unrelated third parties, courts generally have reached the result sought by the IRS, although they have not adopted the IRS's economic family theory. E.g., Clougherty Packing Co. v. Comm'r, 811 F.2d 1297 (9th Cir. 1987).

7. In Rev. Rul. 2001-31, 2001-25 I.R.B. 1 (June 4, 2001), the IRS announced that because no court had fully accepted its economic family theory, it would no longer invoke the theory with respect to captive insurance arrangements. The IRS will continue to apply a "facts and circumstances" test to captive arrangements.

8. Rev. Rul. 2002-89, 2002-52 I.R.B. 984, involves two parent-subsidiary captive situations under which a captive subsidiary, S, provides professional liability insurance and reinsurance to its parent company, P, and to other parties unrelated to S or P. In the first situation, 90% of S's total premiums are received from P, and 90% of the risks borne by S are P's risks. In the second situation, less than 50% of S's total premiums are received from P, and less than 50% of the risks borne by

S are P's risks. The ruling holds that the first (90%) arrangement lacks the requisite risk shifting and risk distribution to constitute insurance for tax purposes and, thus, that premiums paid by P are not deductible as "insurance premiums" under section 162, but that the second (less-than 50%) arrangement possesses the requisite risk shifting and risk distribution to constitute insurance for tax purposes and, thus, that premiums paid by P are deductible as "insurance premiums" under section 162.

F. Distribution of Risk

1. The IRS states that to have insurance, there must be not only the shifting of risk, but also risk distribution. The IRS says that risk distribution occurs when the insurer insures many independent risks, in return for numerous premiums, so that premiums are pooled and each insured is not in significant part paying for its own risks. LTR 200453012 (Sept. 15, 2004).

2. The IRS takes the position that if an insurance company issues a single "insurance" contract to only one policyholder, the risk distribution requirement is not satisfied, and there is no insurance. The IRS says that the transaction may be an indemnity arrangement that is not an insurance contract. Rev. Rul. 2005-40. See PLR 200715012 (Jan. 11, 2007) and PLR 200724036 (March 20, 2007).

G. Brother/Sister Captive Arrangements

1. Applying the "balance sheet" test, the Sixth Circuit has held that, while insurance does not exist in a parent/subsidiary captive arrangement, it can exist in a brother/sister captive arrangement, since the insured does not own the captive. Humana, Inc. v. Comm'r, 881 F.2d 247 (6th Cir. 1989).

2. In Humana, there were over twenty insured entities, those entities were denied traditional insurance by unrelated insurers, the captive was adequately capitalized, and there were no indemnification or hold-harmless agreements.

3. In Malone & Hyde v. Comm'r, also involving a brother/sister arrangement, there were facts that negated risk shifting and led the court to find that there was no "insurance." 95-2 U.S.T.C. ¶50,450 (6th Cir. 1995). The insureds could have been insured by unrelated insurers, the captive was undercapitalized, and hold-harmless agreements negated the risk.

4. The IRS has conceded a number of captive issues involving brother/sister arrangements. See, e.g., FSA 200029010 (April 24,

2000); FSA 200043012 (June 19, 2000); FSA 200105014 (Oct. 26, 2000).

5. Rev. Rul. 2002-90, 2002-52 I.R.B. 985, involves a brother-sister captive situation under which a captive subsidiary, S, provides professional liability insurance directly to 12 operating subsidiaries of S's parent company, P. S does not provide insurance to any party unrelated to S or P. Each operating subsidiary's percentage of the total risk borne by S ranges from 5% to 15%. The ruling holds that the arrangement possesses the requisite risk shifting and risk distribution to constitute insurance for tax purposes and, thus, that premiums paid by the operating subsidiaries are deductible as "insurance premiums" under section 162.

6. If there is only one insured brother/sister, there may be a question whether risk distribution exists. Rev. Rul. 2005-40; Notice 2005-49.

H. <u>Captives and Reinsurance Arrangements</u>

1. To the extent insurance risks are retained within the economic family, premiums paid are not deductible. Rev. Rul. 77-316, 19772 C.B. 53. <u>But</u> <u>see</u> <u>Humana</u>.

2. To the extent insurance risks are transferred out of the economic family by reinsurance, premiums paid are deductible. <u>But</u> <u>see</u> <u>Malone & Hyde</u>.

3. The IRS has argued that the use of a wholly-owned offshore reinsurance company to shift income away from the U.S. parent company is a sham transaction lacking economic substance. The Eleventh Circuit held that such a transaction was bona fide and had economic effect. <u>United Parcel Service v. Commissioner</u>, 254 F.3d 1014 (11th Cir. 2001), <u>rev'g</u> T.C. Memo. 1999-268. <u>See</u> <u>also</u>, FSA 200027008 (March 31, 2000).

4. Beginning in 2002, the IRS challenged producer-owned reinsurance companies ("PORCs") on three theories: (1) the reinsurer is not an "insurance company" for tax purposes; (2) premium income may be reallocated from the reinsurer to the taxpayer/owner under section 482 or 845; and (3) the arrangement is a sham in fact or a sham in substance. Notice 2002-70, 2002-44 I.R.B. 1. The PORC arrangement that the IRS was challenging was typically an offshore reinsurance company that was wholly owned by an insurance salesperson or salespeople, and reinsured risks under policies sold by its owners. These transactions were considered "listed transactions" for purposes of tax shelter disclosure, registration, and list maintenance rules. After examining the issue more closely, the IRS revoked the PORC notice

and removed PORCs from "listed transaction" status. See IRS Notice 2004-65, 2004-41 I.R.B. 599.

I. Third-Party Insurance Risks Assumed by Wholly-Owned Captives

1. The IRS initially ruled that a valid insurance arrangement exists when the captive has at least 50% unrelated insurance risks. O.M. 19167 (Sept. 28, 1979); GCM 38136 (Oct. 12, 1979); LTR 8111087 (Dec. 18, 1980).

2. The current position of the IRS is that third party insurance risk is irrelevant and that it will not create a valid insurance arrangement. GCM 39247 (June 27, 1984); Rev. Rul. 88-72, 1988- 2 C.B. 31.

3. In Gulf Oil Corp. v. Comm'r, 89 T.C. 1010, 1027 n.14 (1987) the Tax Court in dictum stated that a valid insurance risk may exist if the captive has at least 50 percent unrelated risks.

4. The courts have recognized that insurance exists in situations involving unrelated risks. See Sears, Roebuck & Co. v. Comm'r, 96 T.C. 61 (1991), aff d, 92-2 U.S.T.C. ¶50,426 (7th Cir. 1992) (99% outside risk); AMERCO v. Comm'r, 96 T.C. 18 (1991), aff'd, 92-2 U.S.T.C. ¶50,571 (9th Cir. 1992) (over 50% outside risk); and Harper Group v. Comm'r, 96 T.C. 45 (1991), aff'd, 92-2 U.S.T.C. ¶50,572 (9th Cir. 1992) (30% outside risk). See also Ocean Drilling v. U.S., 92-1 U.S.T.C. ¶50,018 (Cl. Ct. 1991) (44-66% outside risk).

5. Treasury has proposed to treat a captive as an insurance company and its insurance as true "insurance" if 50 percent or less of the captive's premiums are attributable to "large-shareholder risks." A large shareholder would be defined as a 10-percent or greater shareholder.

J. Third-Party Ownership of Captives

1. In Rev. Rul. 78-338, 1978-2 C.B. 107, the IRS ruled that there is "insurance" when there are 31 insured shareholders, none of whose coverage exceeds 5 percent of the total. See also Rev. Rul. 80-120, 1980-1 C.B. 41.

2. Rev. Rul. 2002-91, 2002-52 I.R.B. 991, involves an industry captive situation under which a small number (i.e., at least 7) of unrelated businesses form a group captive, GC, that provides liability insurance to members only. No GC member owns more than 15% of GC or possesses more than 15% of the voting rights in GC, and no member's insured risk exceeds 15% of the total risk borne by GC. The ruling holds that (1) the arrangement between GC and its members constitutes "insurance" for tax purposes, (2) insurance premiums paid by GC's members are deductible as "insurance premiums" under

section 162, and (3) GC will be taxable as an “insurance company” under section 831.

K. Captives in Consolidated Groups

1. Under proposed regulations issued in 2007 (Prop. Treas. Reg. § 1.1502-13(e)(2)), if a captive insures risks of other members in the consolidated group, and if those risks exceed 5 percent of the total risks insured by the captive, the unearned premium and unpaid loss reserves are disallowed.

2. This would disallow brother/sister captive insurance in the group, and would raise the level of third-party risk required to 95 percent.

L. Subpart F Income (“Offshore Captives”)

1. If the captive insurer is a foreign corporation, the Subpart F rules may apply.

2. Under Subpart F, certain income of a “controlled foreign corporation” (CFC) is taxable to its “U.S. shareholders.” Section 951.

3. Generally, one method of avoiding the scope of Subpart F is to ensure that the CFC is widely-held.

4. However, the 1986 Act greatly expanded the reach of Subpart F, reducing the ownership requirements and providing that the income of widely-held offshore captives may be currently taxable to their shareholders. Section 953(c).

5. The 1988 TAMRA enacted section 953(d), which allows foreign captives to elect to be taxed as domestic corporations.

   a. If a 953(d) election is made, then the foreign insurance company will be taxed as a domestic company, and the Subpart F rules will not apply.

   b. To make the election, the company must qualify as an insurance company.

M. Excise Tax on Premiums

1. Section 4371 imposes an excise tax on insurance premiums paid to foreign insurers and reinsurers.

2. However, this excise tax may be waived by tax treaty for captives located in certain countries. See, e.g., LTR 9629021 (Apr. 23, 1996) (U.S.-Sweden income tax treaty applied); LTR 9623009 (Feb. 29,

1996) (U.S.-Spain income tax treaty applied); LTR 9618024 (Feb. 5, 1996) (U.S.-Germany tax treaty applied).

3. In U.S. v. I.B.M., 517 U.S. 843 (1996), the Supreme Court held that the section 4371(1) excise tax cannot be constitutionally applied to goods in transit. The I.B.M. decision led to many excise tax refunds. See IRS Notice 96-37, 1996-2 C.B. 208.

N. Protected Cell Company (or PCC)

1. A protected cell company is similar to a captive except that the captive establishes multiple accounts, or cells, each of which is identified with a specific participant. The cell is not treated as a legal entity distinct from the protected cell company.

2. Each cell is funded by its participant's capital contribution and by premiums collected with respect to contracts to which the cell is a party.

3. The assets allocated to each cell may only be liable for liabilities incurred by such cell and are statutorily protected from the creditors of any other cell and from the creditors of the captive.

4. In Notice 2008-19, 2008-5 I.R.B. 366, the IRS has requested comments on proposed guidance that would address (a) when a cell of a Protected Cell Company is treated as an insurance company for federal income tax purposes, and (b) some of the consequences of the treatment of a cell as an insurance company.

5. In Rev. Rul. 2008-8, 2008-5 I.R.B. 340, the IRS determined the following:

   a. An arrangement between one cell of a Protected Cell Company and that cell's sole insured shareholder was not an insurance contract. The arrangement lacked the requisite risk shifting and risk distribution because any claim payment to the sole shareholder would be paid out of that shareholder's premium payments.

   b. The arrangements between another cell of the same Protected Cell Company (where the sole cell shareholder also owned 12 domestic subsidiaries) and each of the 12 insured subsidiaries were insurance contracts since all premiums were pooled and any loss was to be paid from the pool. Since there was risk shifting and risk distribution, the premiums paid by each subsidiary were deductible.

III. Other Alternatives to Commercial Insurance

A. Funded Agreements to Share Liability

1. Pooled Self-Insurance Funds

a. Employers that self-insure their workmen's compensation liability may pool their liabilities. "Premiums" are paid into a fund, which is managed by a trustee.

b. The IRS has ruled that such funds are taxable as mutual P&C insurance companies. (e.g., LTR 8405034 (Oct. 31, 1983))

c. The 1986 Act imposed a moratorium on audits of such funds. 1986 Act section 1879(q). The 1988 Act provided additional relief for years beginning before 1987. TAMRA Section 6076.

2. Risk Retention Groups

a. Under the Product Liability Risk Retention Act of 1981, 15 U.S.C. sections 3901-04, product sellers may form "risk retention groups" to pool their risk of exposure to liability.

b. The Act grants risk retention groups a limited exemption from duplicative and overlapping state regulation.

c. As enacted in 1981, the Act applied only to product liability. E.g., Home Warranty Corp. v. Elliott, 585 F. Supp. 443 (D. Del. 1984). In 1986, it was expanded to cover all types of liability insurance.

d. Such a group would be taxable, most likely as a P&C insurance company.

B. Unfunded Agreements to Share Liability

1. Another alternative is to structure an arrangement that does not involve the formation of any new taxable entity. The parties to the agreement simply agree to pay portions of a loss suffered by any member, when such a loss occurs.

2. The payments should be deductible by the payers, and includible in the income of the recipient, in the year in which the third party claims are settled. See LTR 8032087 (May 15, 1980).

EXAMPLE #1: EXPERIENCE METHOD

Taxable year - 1985
Base year - 1984
Outstanding loans as of 12/31/84 - $1,100,000
Bad debt reserve balance as of 12/31/84 - $25,000

Six year moving average amount:

Year	Bad Debts Sustained	Loans Outstanding
1985	$32,000	$1,250,000
1984	$25,000	$1,100,000
1983	$18,000	$1,050,000
1982	$15,000	$ 900,000
1981	$16,000	$ 800,000
1980	$14,000	$ 800,000
Totals	$120,000	$5,900,000

(6-yr avg. amt./current loans) = (total bad debts/total loans)
6-year avg. amount = $1,250,000 x ($120,000 / $5,900,000)
6-year avg. amount = $25,424

A. Base year amount:

Balance of reserve at 12/31/84 -	$25,000
Because the amount of loans outstanding at the close of 1985 is not less than the amount of loans outstanding at the close of the base year, the base year reserve is not adjusted.	
Base year amount -	$25,000

B. Maximum reserve addition:

Reserve as of 12/31/84 -	$25,000
Assume net charge off for 1985	($ 5,000)
	$20,000
Allowable reserve (greater of A and B above) -	$25,424
Maximum reserve addition -	$ 5,424

EXAMPLE #2: EXPERIENCE METHOD

Taxable year - 1985
Base year - 1984
Outstanding loans as of 12/31/84 - $1,000,000
Bad debt reserve balance as of 12/31/84 - $20,000

Six year moving average amount:

Year	Bad Debts Sustained	Loans Outstanding
1985	$25,000	$ 950,000
1984	$20,000	$1,000,000
1983	$18,000	$1,050,000
1982	$15,000	$ 900,000
1981	$16,000	$ 850,000
1980	$14,000	$ 800,000
Totals	$108,000	$5,550,000

(6-yr avg. amt./current loans) = (total bad debts/total loans)
6-year avg. amount = $950,000 x ($108,000 / $5,550,000)
6-year avg. amount = $18,485

A. Base year amount:

Balance of reserve at 12/31/84 -	$20,000

Adjusted reserve balance -

(Adj. res. amt./current loans) = (base yr. reserve/base yr. loans)

Adj. res. amount = $20,000 x ($950,000 / $1,000,000)

Adjusted reserve amount -	$19,000
Base year amount (lesser of above) -	$19,000

B. Maximum reserve addition:

Reserve as of 12/31/84 -	$20,000
Assume net charge off for 1985	($ 5,000)
	$15,000
Allowable reserve (greater of A and B above)	$19,000
Maximum reserve- addition -	$4,000

EXAMPLE #3: BANK BECOMES "LARGE BANK"

Assume:

1. Prior to 2008, the average adjusted bases of all of Bank's assets were less than $500 million.

2. As of year-end 2008, Bank held a reserve for bad debts, computed using the experience method, in the amount of $20 million.

3. In all years prior to 2008, Bank only made loans to businesses located in Delaware.

4. In 2009, Bank made no new Delaware loans, but began to make loans to businesses located in New Jersey.

5. In 2009, Bank charged off as worthless $2 million of Delaware loans and $1 million of New Jersey loans.

6. Through 2008, Bank was using the experience method per section 585.

For the year 2009, explain what choices that Bank must make regarding its reserve for bad debts for the year 2009 and later years, and explain how Bank can compute its year 2009 deduction for bad debts with respect to its loans.

In 2009, Bank becomes large bank and must make an adjustment under one of two available options:

> <u>Option 1</u>: Bring the $20M year-end reserve balance into income over a 4-year period (2M, 4M, 6M, and 8M).
>
> In the alternative, Bank can increase the 2009 amount and then bring the remaining amount into reserves over the next three years on the basis of 2/9, 3/9, and 4/9.
>
> Under this option, the deduction for 2009 is the $3M of bad debts charged off.
>
> <u>Option 2</u>: Use the elective cut-off method.
>
> For Delaware loans, charge the $2M of bad loans against the reserve, reducing it from $20M to $18M. Keep doing this until the reserve reaches zero, then start to deduct the charge offs. If the reserve exceeds outstanding Delaware loans, the excess is income.
>
> Under this option, the deduction equals the $1M charge off of New Jersey loans.

EXAMPLE #4: THRIFT BECOMES A "LARGE BANK"

Assume:

1. Year end 1987 reserve is $80
2. Year end 1995 reserve is $200
3. In 1996, Thrift uses specific charge-off method

The section 481 adjustment –

$120 ($200 minus $80)

Bring $120 section 481 adjustment into income ratably over 6 years

Assume Thrift subsequently ceases to be a bank.

The section 481 adjustment was $120; $80 of reserve got a fresh start

If cease to be a "bank" after 1995, bring $80 fresh start amount into income ratably over 6 years

EXAMPLE #5: THRIFT BECOMES A "SMALL BANK"

Assume:

1. Year end 1987 reserve is $80.
2. Year end 1995 reserve is $200.
3. Beginning of year 1996 reserve on Experience Method is $140.

The section 481 adjustment –

$60 ($200 minus $140)

Bring $60 section 481 adjustment into income ratably over 6 years.

Assume: the thrift becomes a "large bank," the reserve remained $140, and the thrift started using the specific charge-off method

Treatment of the $140 ending reserve:

$80 of the reserve is pre-1988 reserves, and gets a fresh start

$60 of the reserve is post-1987 reserves, and is either: (1) the section 481 adjustment brought into income under section 585 over 4 years, or (2) the amount of the reserve that is run off

Assume: thrift then ceases to be a bank.

Bring $80 fresh start amount into income ratably over 6 years

EXAMPLE #6: PRORATION (SECTION 291)

Assume

1. T/E obligation acquired in 1984
2. Basis of such tax-exempt obligations is $20M
3. Basis of all assets is $100M

What percentage of the interest expense is "allocable to" T/E?

$$\frac{\text{interest allocable to tax-exempt obligations}}{\text{total interest deduction}} = \frac{\$20}{\$100}$$

Answer: 20%

Assume interest expense is $10 M

$2M of interest expense is "allocable to"

Thus, 20% of the $10M interest expense or $2M is "allocable to"

Rule: Disallow 20% of interest "allocable to" these T/E, or $400,000

EXAMPLE #7: PRORATION (SECTION 265)

Assume

1. T/E obligation acquired in 1984

2. Basis of such tax-exempt obligations is $20M

3. Basis of all assets is $100M

What percentage of the interest expense is “allocable to” T/E?

$$\frac{\text{interest allocable to tax-exempt obligations}}{\text{total interest deduction}} = \frac{\$20}{\$100}$$

Answer: 20%

Assume interest expense is $10M

$2M of interest expense is “allocable to”

Thus, 20% of the $10M interest expense or $2M is “allocable to”

Rule: Disallow 100% of interest “allocable to” these T/E, or $2M

EXAMPLE #8: PRORATION

During 2008, Bank had total assets with average adjusted bases totaling $5 million. These total assets consisted of the following:

Real estate	$1,000,000
Taxable bonds	$1,000,000
Common stock	$ 500,000
Tax-exempt obligations acquired before September 1, 1981	$ 750,000
Tax-exempt obligations acquired during 1983 and 1984	$ 500,000
Tax-exempt obligations acquired after September 1, 1992	$1,250,000

In 2000, Bank and the issuer of the tax-exempt obligations issued before September 1, 1981, renegotiated the interest rate that is payable to Bank under the obligations from 3 percent to 5 percent.

During the year 2008, Bank has $1,000,000 of interest expense, as follows:

Interest paid on savings deposits	$ 550,000
Interest paid on commercial debt	$ 300,000
Interest paid on mortgage debt	$ 150,000
Total interest expense	$1,000,000

For the year 2008, Bank has asked you to explain how it should compute the amount of its interest expense that is allowed as a deduction, and to state what the amount of that deduction is.

The tax-exempt obligations acquired before 1981 were not initially subject to proration. However, in 2000 PINC and the issuer made a material change in the terms of the obligations.

The tax-exempt obligations acquired in 1983 and 1984 are subject to 291.

> $500,000/$5,000,000 or 10 percent of the $1,000,000 interest expense is allocable to these obligations.
>
> Of the $100,000 of interest expense allocable to the 1983/1984 obligations, 20 percent or $20,000 is disallowed.

Adding the newly "acquired" obligations to the post-1992 obligations gives T/E's with a basis of $2,000,000 that are subject to 265.

> $2,000,000/$5,000,000 is 40 percent, so 40 percent of interest expense is allocable to these obligations, which is $400,000.

Total interest disallowed by 291 and 265 is $420,000

Total interest expense allowed as a deduction is $1,000,000 - $420,000 = $580,000

EXAMPLE #9: FORECLOSURES

	Example A	Example B	Example C
Mortgage indebtedness	$100,000	$100,000	$100,000
Foreclosure bid price	$ 50,000	$100,000	$ 80,000
Bad debt deduction	$(50,000)	$0	$(20,000)
Indebtedness applied to bid price	$50,000	$100,000	$80,000
Fair market value	$50,000	$ 50,000	$90,000
Gain (or loss)	$0	$(50,000)	$10,000

EXAMPLE #10: RIC SOURCE OF INCOME REQUIREMENT

	Amount	"Gross Income"
Taxable Interest	$500	$500
Tax-Exempt Interest	$400	$400
Gain on stock sales	$500	$500
Loss on stock sales	($300)	
Rent income	$100	$100

"Good" Income = $1,400

Gross Income = $1,500

$1,400/$1,500 = 93%

EXAMPLE #11: RIC INVESTMENT REQUIREMENTS

A. RIC owns the following assets:

	Percent of Total Assets
Cash	5
Government securities	10
Other RIC securities	20
Corporation A securities	20
Corporation B securities	5
Various corporate securities (not exceeding 5 percent of RIC assets per corporation)	40
	100

The RIC owns 10 percent of the stock of Corporation A.

The RIC owns 20 percent of the stock of Corporation B, and less than 10 percent of the stock of the other corporations.

The RIC has 75 percent of its assets invested in compliance with the 50-percent test of section 851(b)(3)(A).

EXAMPLE #12: RIC INVESTMENT REQUIREMENTS

l. A section 851(e) venture capital RIC, on March 31, 1990, purchases 1,000 shares of Research Corp. stock (100 percent of the corporation's stock) for $30,000.

   On March 31, 1990, the value of the RIC's total assets is $1,000,000.

   Thus, the RIC's investment in Research Corp. stock is 3 percent of the value of its total assets.

   The stock is counted for purposes of computations under the 50-percent test.

2. On March 31, 1998, the value of the RIC's total assets is $1,500,000.

   On March 31, 1998, the value of the 1,000 shares of Research Corp. owned by the RIC is $60,000. On that date, the RIC purchases an additional 500 shares for $30,000.

   The value of the 1,500 shares of Research Corp. stock ($90,000) is 6 percent of the value of its total assets.

   However, the basis of those shares ($60,000) is only 4 percent of the value of total assets as of March 31, 1998.

   Thus, the investment is counted in computations under the 50-percent test of section 851(b)(3)(A), as modified by section 851(e).

EXAMPLE #13: RIC INVESTMENT REQUIREMENTS

A RIC owns the following assets:

	Percent of Total Assets
Cash	20
Corporation A securities (a RIC)	20
Corporation B securities	10
Corporation C securities	25
Various corporate securities (not exceeding 5 percent of RIC assets per corporation)	25
	100

Part A: Assume Corporations A, B and C are unrelated and in different businesses. The section 851(b)(3)(B) test is satisfied.

Part B: Assume Corporations A, B and C are unrelated, but that Corporation B manufactures radios and Corporation C retails radios. Assume that the RIC owns 20 percent of both Corporations B and C. The section 851(b)(3)(B) test is failed.

Part C: Assume that Corporation A has invested 25 percent of its assets in Corporation X, which in turn has invested 25 percent of its assets in Corporation C. The RIC has directly invested 25 percent of its assets in corporation C. The RIC-A-X-C chain of corporations is connected through 20-percent stock ownership. The RIC is deemed to have invested another 1.25 percent (20 percent of 25 percent of 25 percent) of its assets in Corporation C indirectly. Thus, the section 851(b)(3)(B) test is failed.

EXAMPLE #14: REIT INCOME REQUIREMENTS

A REIT has the following income:

Rents from real property	$115
Interest on mortgage loans secured by property	$10
Income from foreclosure property	$25
Interest income	$20
Dividends	$18
Other income	$12
Total	**$200**

- 75% Test
    - Rents from real property = $115
    - Interest on mortgage loans secured by property = $10
    - Income from foreclosure property = $25
    - Total = $150
    - $150/$200 = 75% and test is met
- 95% Test
    - Income from sources specified in the 75% test = $150
    - Interest income = $20
    - Dividends = $18
    - Total = $188
    - $188/$200 = 94% and test is not met

EXAMPLE #15: REIT INVESTMENT REQUIREMENTS

A REIT owns the following assets:

	Percent of Total Assets
Cash	5
Government securities	10
Real estate assets	60
Corporation A securities	20
Corporation B securities	5
	100

- Assume that the REIT owns 100 percent (by voting power and value) of the outstanding securities of Corporation A and 10 percent (by voting power and value) of the outstanding securities of Corporation B. Further assume that Corporation A is a taxable REIT subsidiary, while Corporation B is not.

- The REIT has 75 percent of its assets invested in compliance with section 856(c)(4)(A).

- Not more than 20 percent of the value of the REIT's assets are represented by securities of taxable REIT subsidiaries, in compliance with section 856(c)(4)(B)(ii).

- The REIT also complies with the section 856(c)(4)(B)(iii) test. Except for government securities and the securities of a taxable REIT subsidiary, the REIT does not have over 5 percent of the value of its total assets invested in the securities of one issuer. Likewise, except for its taxable REIT subsidiary, the REIT does not own more than 10 percent of the value or voting power of the securities of any one issuer. If Corporation A was not a taxable REIT subsidiary, the REIT would fail the 25 percent test.

EXAMPLE #16: REIT DISTRIBUTION REQUIREMENTS

During the year 2008, REIT had the following amounts of income and expenses:

	Amounts
Rent income	$700,000
Mortgage interest income	$300,000
Cancellation of indebtedness income	$100,000
Net capital gain	$100,000
Income from prohibited transactions	$100,000
Income from foreclosure property	$150,000
Expenses connected with rent income	$(100,000)
Expenses connected with foreclosure income	$ (50,000)

For the year 2008, explain how REIT should calculate the amount of dividends that REIT must distribute to its shareholders in order to qualify as a real estate investment trust.

First, compute REITTI without regard to dividends paid and excluding net capital gain:

Rent	$	700,000
Mortgage Interest	$	300,000
COI	$	100,000
Rent Expense	$	(100,000)
	$	1,000,000

90% of $1,000,000 is $900,000

Second, compute net foreclosure income:

Income	$	150,000
expenses	$	(50,000)
	$	100,000
35% tax	$	35,000
	$	65,000

90% of $65,000 is $58,500

Third, compute excess noncash income

noncash income	$	100,000
5% REITTI	$	(50,000)
	$	50,000

The REIT must distribute $900,000 plus $58,500 minus $50,000 = $908,500

EXAMPLE #17: REIT TAXATION

During the year 2009, REIT had the following amounts of income and expenses:

	Amounts
Rent income	$875,000
Taxable mortgage interest income	$205,000
Foreclosure income	$175,000
Prohibited transaction income	$ 50,000
Expenses connected with rent income	$(80,000)
Expenses connected with foreclosure income	$(75,000)
Expenses connected with prohibited transactions	$(20,000)

During the year 2009, REIT distributes as dividends paid to its shareholders non-foreclosure income (*i.e.*, rent and taxable interest income) in the amount of $900,000, and also distributes as dividends paid to its shareholders foreclosure income in the amount of $65,000.

During the year 2009, REIT met all of the tests necessary to qualify as a real estate investment trust, and had no taxable REIT subsidiary. During 2009 REIT was subject to a 35 percent federal income tax rate.

For the year 2009, explain how REIT should calculate the amount of federal income taxes that it owes.

First, compute tax on REITTI (exclude foreclosure and prohibited transaction income).

Rent	$875,000
Mortgage Interest	$205,000
Rent Expense	($80,000)
	$1,000,000
Dividend	($900,000)
	$100,000

At 35%, the tax is $35,000.

Second, calculate tax on foreclosure income.

Foreclosure	$175,000
Expenses	($75,000)
	$100,000

At 35%, the tax is $35,000.

Third, the tax on prohibited transaction income is 100% of net income.

Prohibited	$50,000
Expenses	($20,000)
	$30,000

At 100%, the tax is $30,000.

Total tax = $35,000 + $35,000 + $30,000 = $100,000

EXAMPLE #18: CLOSED CASE METHOD OF TESTING UNPAID LOSS RESERVES

Year under examination - 1988

The test will examine unpaid loss reserves for cases that are open as of the end of 1981, 1982, and 1983.

The test will divide those cases into two groups: those that have been closed as of 1988, and those that still remain open as of 1988.

As to cases closed during that development period, the test will determine the payments made on those cases through 1988. Payments made after 1988 may also be considered.

This test is performed separately for each line of business.

Payments made, with respect to cases open at the end of the test year, but closed through 1988, during the year of:

Test Year	1982	1983	1984	1985	1986	1987	1988
1981	$1,000	$1,800	$1,100	$3,000	$ 300	$ 500	$ 700
1982		$1,900	$1,600	$2,300	$ 800	$1,000	$ 500
1983			$2,000	$2,500	$1,900	$1,200	$ 500

Test Year	Loss Reserve	Total Payments	Experience Rate
1981	$8,900	$8,400	106%
1982	$9,400	$8,100	116%
1983	$9,000	$8,100	111%

111% = Average experience rate

Unpaid Loss Reserve claimed for 1988 = $15,000

Allowable reserve ($15,000 / 1.11) = $13,513

Audit adjustment $ (1,487)

EXAMPLE #19: AGE-TO-ULTIMATE METHOD OF TESTING UNPAID LOSS RESERVES

Assume a line of business has been written for several years. Also assume that paid losses develop to "ultimate" amounts (i.e., all losses are paid) within five years, as shown by the first line in the following array:

Accident Year (AY)	Losses Paid (Cumulative) AY	AY + 1	AY + 2	AY + 3	AY + 4
1	$5,000	$25,000	$45,000	$70,000	$100,000
2	$6,000	$20,000	$50,000	$80,000	
3	$8,000	$30,000	$55,000		
4	$5,000	$35,000			
5	$9,000				

Based on the information for Accident Year 1, it can be determined that the percent of losses paid relative to ultimate losses, on a cumulative basis, is as follows:

	Losses Paid (Cumulative)			
AY	AY + 1	AY + 2	AY + 3	AY + 4
5%	25%	45%	70%	100%

Using these percentages, and the information regarding paid losses to date, it is possible to determine for the other years (Accident Years 2 through 5) what expected ultimate losses will be paid, as follows:

Accident Year	Losses Paid to Date	Percent of Ultimate Losses Paid	Projected Ultimate Losses to Be Paid
2	$80,000	70%	$114,285
3	$55,000	45%	$122,222
4	$35,000	25%	$140,000
5	$ 9,000	5%	$180,000

By subtracting “Losses Paid to Date” from the “Projected Ultimate Losses to Be Paid,” it is possible to estimate the amount of the remaining losses to be paid:

Accident Year	Projected Ultimate Losses to Be Paid	Losses Paid to Date	Remaining Losses to be Paid
2	$114,285	$80,000	$ 34,285
3	$122,222	$55,000	$ 67,222
4	$140,000	$35,000	$105,000
5	$180,000	$ 9,000	$171,000

The “Remaining Losses to Be Paid” should equal the amount of loss reserves held by the company.

If the company is holding larger reserves, the IRS may conclude that the reserves are redundant and propose an adjustment.

EXAMPLE #20: RESERVES FOR UNEARNED PREMIUMS

Assume that a P&C insurer has the following unearned premium reserves:

Year End	Reserve	80 Percent of Reserve
12/31/85	$1,000,000	$ 800,000
12/31/86	1,200,000	960,000
12/31/87	1,500,000	1,200,000

1. Year 1986

   The increase in the reserve for unearned premiums ($200,000) is allowed as a deduction, in full.

2. Year 1987

   A. The increase in the reserve for unearned premiums ($300,000) is reduced by 20 percent, or $60,000. Thus, only 80% of the reserve increase, or $240,000, is deductible.

   B. Under the 80-percent rule of the 1986 Act, the year-end 1986 reserve is reduced by $240,000. This amount is included in income ratably over a six-year period. Thus, $40,000 ($240,000 divided by 6; or, $1,200,000 times 3-1/3 percent) is includible in income for 1987 (and each of the next five years).

EXAMPLE #21: LOSSES INCURRED

Assume: $500,000 losses paid during 1993.
$100,000 salvage and reinsurance recovered during 1993.

Assume: $800,000 tax-exempt interest received during 1993.

Assume:

Year End	Unpaid Losses	Unpaid LAE
12/31/92	$1,000,000	$100,000
12/31/93	1,300,000	200,000

Assume:

Year End	Estimated Salvage Recoverable
12/31/92	$300,000
12/31/93	400,000

Note: The amounts shown above have not been discounted.

Computation of "Losses Incurred" for the Year 1993:

A. Losses paid - $500,000
Salvage recovered - $100,000
$400,000 $400,000

B. Unpaid LAE are included in unpaid losses. Thus, the undiscounted unpaid loss reserves total $1,100,000 (12/31/92) and $1,500,000 (12/31/93).

C. Unpaid loss reserves must be discounted. Assume that for 1992 and 1993 the discounting reduces the reserves by 20 percent:

Year End	Undiscounted Reserve	Discounted Reserve	
12/31/92	$1,100,000	$880,000	
12/31/93	1,500,000	1,200,000	
		$ 320,000	$320,000

D. Estimated salvage recoverable must be discounted. Assume that for 1992 and 1993 the discounting reduces the estimate by 20 percent:

Year End	Undiscounted Estimate	Discounted Estimate	
12/31/92	$300,000	$240,000	
12/31/93	400,000	320,000	
		$80,000	($ 80,000)

E.	Tentative losses incurred	$640,000
F.	Reduce the tentative deduction by 15 percent of tax-exempt interest.	
	$800,000 15% $120,000	
		($120,000)
G.	Losses incurred --	$520,000

EXAMPLE #22: PROPERTY/CASUALTY INSURANCE COMPANY TAXABLE INCOME

During the year 2008, a property/casualty insurance company wrote premiums totaling $200,000,000, received taxable interest totaling $40,000,000, and received tax-exempt interest totaling $20,000,000 (attributable to tax-exempt bonds acquired in 1995). During the year 2008, the company also received recoveries of salvage (attributable to its automobile insurance line of business) totaling $4,000,000.

During the year 2008, the company paid to its policyholders insurance claims totaling $20,000,000, and paid expenses totaling $31,000,000. During 2008, the company also paid premiums on reinsurance policies in the amount of $300,000.

As of the end of the year 2007 and the end of the year 2008, the company had the following amounts of discounted unpaid losses, the following amounts of discounted estimated salvage recoverable, and the following amounts of unearned premium reserves:

Year	Discounted Unpaid Losses	Discounted Estimated Salvage Recoverable	Unearned Premium Reserves
2007	$200,000,000	$50,000,000	$ 80,000,000
2008	$300,000,000	$40,000,000	$100,000,000

For the year 2008, explain how the company should compute its "taxable income."

Taxable income is computed under section 832:

Investment income	$40,000,000	(60K - 20K tax-exempt portion)
Premiums written	$200,000,000	
Reinsurance premiums	($300,000)	
80% of Unearned Premiums	($16,000,000)	(80% of $20,000,000 increase in reserve)
Earned Premiums	$183,700,000	
Losses Paid	$20,000,000	
S&S recovered	($4,000,000)	
Disc. Unpaid Losses	$100,000,000	
S&S recoverable	$10,000,000	
15% of T/E interest	($3,000,000)	= 15% of T/E interest of $20,000,000
15% of DRD		
Losses incurred	$123,000,000	
Expenses incurred	$31,000,000	

Taxable income = investment income of $40,000,000 + earned premiums of $183,700,000 - losses incurred of $123,000 - expenses incurred of $31,000,000 = $69,700,000.

EXAMPLE #23: RESERVE THEORY

Assume 300 policyholders each purchase one whole life insurance policy with a face amount of $1,000 per policy.

Assume annual premiums of $100, of which the net valuation portion is $60 and loading is $40.

Assume that the assumed rate of interest is zero.

Upon issuance of the policies, and before any premiums are received, the present value of future benefits is $300,000. The present value of net future premiums is also $300,000 (this reflects the way that net premiums are determined).

After 10 years, net premiums of $180,000 have been received. Assume that:

1. 100 policyholders have died
2. $100,000 in benefits have been paid

Retrospective computation

Total of premiums paid	$ 180,000
Less: Benefits paid	(100,000)
Reserve	$ 80,000

Prospective Computation

PV of future benefits	$200,000
Less: PV of future net premiums	(120,000
Reserve	$ 80,000

EXAMPLE #24: PRORATION

Assume investment income of: $80 of taxable interest and $20 of tax-exempt interest.

Assume that the policyholders' share is 50%, so that $50 of investment income is credited to reserves as the policyholders' share.

1. $80 investment income (taxable)
   (50) reserve increase
   $30 net income

   In this calculation, the company gets the full (double) benefit of both its tax-exempt interest and its reserve increase.

2. $80 investment income (taxable)
   (30) reserve increase ($50 less $20)
   $50 net income

   In this calculation, the company's reserve increase ($50) is reduced by the full amount of tax-exempt interest ($20). This method was held unconstitutional in National Life Ins. Co. v. Comm'r.

3. $50 company's share of investment income ($40 taxable, $10 tax-exempt) (the policyholders' share is excluded from income)
   (10) company's share of tax-exempt interest
   $40 net income

   In this calculation, the policyholders' share of tax-exempt interest is excluded as part of the investment income credited to reserves. This calculation, utilized in the 1959 Act, was held constitutional in Atlas Life.

4. $80 investment income (taxable)
   (40) reserve increase $50 less $10, the policyholders' share of tax-exempt interest)
   $40 net income

   In this calculation, utilized in the 1984 Act, the reserve increase is decreased by the policyholders' share of tax-exempt interest.

EXAMPLE # 25: PRORATION

During the year 2009, a stock life insurance company had outstanding no participating policies and paid no policyholder dividends. During the year 2009, the life insurance company reported the following amounts of income:

Amount	
Gross premiums received	$550,000,000
Taxable dividends received (attributable to common stock of various public corporations)	$ 12,000,000
Taxable interest received	$158,000,000
Tax-exempt interest received	$ 30,000,000

As of December 31, 2008, the life insurance company reported Code section 807(c) reserves totaling $700,000,000, and of December 31, 2009, the life insurance company reported Code section 807(c) reserves totaling $850,000,000.

For the year 2009, the life insurance company had net investment income of $180,000,000. For the year 2009, the life insurance company's policy interest was $60,000,000.

The dividends that the life insurance company received during 2007 were eligible for the 70 percent dividends received deduction.

The life insurance company has asked you the following question:

For the year 2009, explain what tax calculations that the life insurance company is required to make as a result of its receipt of dividends and tax-exempt interest in 2009.

The life insurance company must prorate both the tax-exempt interest and the DRD.

First, one must compute the company and policyholders share under section 812:

The net investment income is $180M
Policy interest is $60M
Company share of net investment income is $120M
Company share is $120/$180 = 2/3 (66.67%)
Policyholder share is 1-2/3 = 1/3

Second, prorate the tax-exempt interest in the reserve increase calculation:

Closing reserves of $850,000
Less policyholder share of tax-exempt interest = $10,000 ($30,000,000 x 1/3)
Total = $840,000

$840,000 minus opening reserves of $700,000 = reserve increase deduction of $140,000

Third, prorate the DRD:

Dividend received of $12,000,000

Company share of dividends is $8,000,000 ($12,000,000 x 2/3)

Company share of dividends x DRD percentage of 70% = $5,600,00

EXAMPLE #26: DEFERRED ACQUISITION COSTS

Assume:

Group life insurance premiums in 1993 - $100,000,000

Individual life insurance premiums in 1993 - $100,000,000

In 1993, the taxpayer reinsures a block of individual life insurance contracts. Under the reinsurance agreement, the taxpayer (the ceding company) pays the reinsurer a reinsurance premium of $20,000,000. Under the reinsurance agreement, the ceding company pays the reinsurer $4,000,000 of premiums received under the reinsured contracts, and the reinsurer pays the ceding company death benefits and other expenses under the reinsured contracts of $5,000,000.

A. Computation of Specified Policy Acquisition Expenses

1. Group contracts

Net Premiums	$100,000,000	
Percentage	2.05%	
		$2,050,000

2. Individual contracts

Direct	$100,000,000	
Reinsurance	$(20,000,000)	
	(4,000,000)	
	5,000,000	
	$(19,000,000)	
Net Premiums	$ 81,000,000	
Percentage	7.7%	
		$6,237,000
Total		$8,287,000

B. Amortize the total in accordance with sections 848(a) and (b).

EXAMPLE #27: EMPLOYER GROUP TERM LIFE INSURANCE

Corporation pays the premiums on a $65,000 group-term life insurance policy on the life of an employee.
The policy names the spouse of the employee as beneficiary.
The employee pays nothing toward the cost of the insurance.
The tax year is 2000.

The employee is 48 years old.

1.	Total insurance coverage	$65,000.00
2.	"Tax-free" coverage	(50,000.00)
3.	Insurance coverage subject to tax	$15,000.00
4.	Cost per $1,000 of coverage for 1-month period for 48-year old person (see Treas. Reg. § 1.79-3)	$.15
5.	Cost per $1,000 of coverage for year ($.15 times 12)	$1.80
6.	Times number of $1,000s of coverage subject to tax	15.00
7.	Cost of policy includible in employee's income (15 times $1.80)	$27.00

EXAMPLE #28: MODIFIED ENDOWMENT CONTRACTS

On April 1, 1996, Moe and Larry (both individuals) each purchased a life insurance policy issued by a life insurance company as defined by section 816 of the Internal Revenue Code. Each policy provides for a death benefit payable of $500,000, and each policy qualifies as a life insurance contract under section 7702 of the Internal Revenue Code.

Moe purchased a policy that provided for the payment of ten level premiums, each premium in the amount of $10,000. After payment of those ten premiums, the policy provided that the future benefits under the policy were fully paid-up, and that no additional premiums were payable.

In contrast, Larry purchased a policy that provided for the payment of five level premiums, each in the amount of $20,000. After payment of those five premiums, the policy provided that the future benefits under the policy were fully paid-up, and that no additional premiums were payable.

During the year 2007, the policy owned by Moe became eligible for policyholder dividends and Moe was paid a policyholder dividend in the amount of $20,000.

During the year 2008, the policy owned by Moe and the policy owned by Larry each have a cash value of $190,000.

In the year 2008, Moe and Larry seek your advice regarding the following two questions:

1. During the year 2008, Moe would like to receive a partial withdrawal under his life insurance policy in the amount of $115,000. Moe has asked you to explain how the receipt of that partial withdrawal should be treated by him for federal income tax purposes.

2. During the year 2008, Larry would like to receive a policy loan under his life insurance policy in the amount of $135,000. Larry has asked you to explain how the receipt of that policy loan should be treated by him for federal income tax purposes.

Answer to 1:

Moe does not have a MEC.

Moe's investment in the contract is his $100,000 of premiums paid less his $20,000 policyholder dividend, or $80,000.

Moe withdraws basis first. The first $80,000 of the withdrawal is a return of capital. The remaining $35,000 of the withdrawal is income to Moe.

Answer to 2:

Larry has a MEC.

Larry's policy loan is treated as a withdrawal and Larry withdraws income first.

Larry's income in the contract is the $190,000 cash value less the $100,000 investment in the contract, or $90,000. The remaining $45,000 of the withdrawal is return of capital.

Larry also has a 10% penalty of $9,000.

EXAMPLE #29: LIFE INSURANCE DEATH BENEFITS

Death benefit = $100,000

A. Settlement option = Payable in 10 annual installments, plus interest, for a total of $135,000.

In year one, the beneficiary receives		$13,500
1.	Amount received	$13,500
2.	Less: prorated amount of death benefit excludable from income ($100,000/10 years)	(10,000)
3.	Amount includible in income[1/]	$3,500

B. Settlement option = Election to receive annual payments of $6,500, for the life of the beneficiary

Life expectancy of beneficiary, age 65 = 20 years[2/]

Present value, as of the date of death, of the insurance company's obligation to make such payments = $100,000

In year one, the beneficiary receives		$6,500
1.	Amount received	$6,500
2.	Less: Prorated amount of death benefit excludable from income ($100,000/20 years)	(5,000)
3.	Amount includible in income	$1,500

[1/] Under prior law, the first $1,000 of interest received in each year by a surviving spouse was excludable from income. This exclusion was repealed by the 1986 Act.

[2/] See Treas. Reg. § 1.72-9, Table V, Expected Return Multiples. In the case of deaths after October 22, 1986, the Act provides that the determination of life expectancy must be made using "unisex" tables prescribed in Regulations. Section 101(d)(2)(B)(ii); Treas. Reg. § 1.101-7.

EXAMPLE #30: ANNUITY WITHOUT REFUND FEATURE

The taxpayer pays $100,000 for an annuity that will pay $12,500 per year for 10 years.

1.	Investment in the contract	$100,000.00
2.	Expected return (10 times $12,500)	$125,000.00
3.	Exclusion ratio (line 1/line 2)	.80
4.	Amount of each payment excluded from income (.80 times $12,500)	$10,000.00
5.	Amount of each payment included in income	$2,500.00

EXAMPLE #31: ANNUITY WITHOUT REFUND FEATURE

The taxpayer, a male, age 64 as of the annuity starting date, pays $100,000 for an annuity that will pay $6,000 per year for his life.

1.	Investment in the contract			$100,000.00
2.	Expected return			
	a.	Annual payments	$6,000	
	b.	Number of expected payments (Treas. Reg. § 1.72-9, Table V)	20.8	
	c.	Expected return		$124,800.00
3.	Exclusion ratio (line 1/line 2)			.80
4.	Amount of each payment excluded from income (.80 times $6,000)			$ 4,800.00
5.	Amount of each payment included in income			$ 1,200.00

Note: Tables I through IV, which reflect gender, are used if the investment in the contract does not include a post-June 30, 1986 investment in the contract. Unisex tables V through VIII are used if the investment in the contract includes a post-June 30, 1986 investment in the contract.

EXAMPLE # 32: ANNUITY WITH REFUND FEATURE

The taxpayer, a male, age 67 as of the annuity starting date, pays $100,000 for an annuity. The annuity will pay $6,250 per year for his life, but, in any event, will make such payments for a 10-year guarantee period.

1.	Investment in the contract		
	a. Premiums paid	$100,000	
	b. Value of refund feature equals 8 percent of Premiums paid (Treas. Reg. § 1.72-9, Table VII)	8,000	
	c. Investment in the contract		$92,000.00
2.	Expected return		
	a. Annual payments	$6,250	
	b. Number of expected payments (Treas. Reg. § 1.72-9, Table V)	18.4	
	c. Expected return		$115,000.00
3.	Exclusion ratio		.80
4.	Amount of each payment excluded from income (.80 times $6,250)		$ 5,000.00
5.	Amount of each payment included in income		$ 1,250.00

Note: Tables I through IV, which reflect gender, are used if the investment in the contract does not include a post-June 30, 1986 investment in the contract. Unisex tables V through VIII are used if the investment in the contract includes a post-June 30, 1986 investment in the contract.

EXAMPLE #33: TAX-FREE POLICY EXCHANGES

Taxpayer owns a life insurance policy in which his investment is $100,000 (20 annual $5,000 premiums paid.)

The taxpayer has a policy loan of $15,000.

The life insurance policy is exchanged for an annuity policy with a fair market value of $120,000.

1.	Amount realized			
	a.	Policy loan	$15,000	
	b.	Value of annuity	120,000	
	c.	Amount realized		$135,000
2.	Basis			($100,000)
3.	Gain realized		$35,000	
4.	Gain recognized (boot)		$15,000	
5.	Basis of annuity			
	a.	Basis of life insurance contract	$100,000	
	b.	Less: Money received	($15,000)	
	c.	Plus: Gain recognized	$15,000	
	d.	Basis of annuity	$100,000	

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