TAXATION OF FINANCIAL INSTITUTIONS

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LL.M. Taxation Program

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*** Note: This outline was prepared by Professor Johnson and does not reflect the views or positions of the IRS or Professor MacIvor**

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ASSIGNMENTS AND COURSE READING LIST

I. TAXATION OF BANKS AND THRIFTS

A. Required Reading

Code Sections:

Generally §§581-597; §501(c)(1)&(14); §581; §7701(a)(19); §591(a)-(b); §542(c)(2); §166; §165(f)-(g); §1211; §582(a)-(c); §585; §1001; §1221; §172(b)(1)(D); §593; §291; §481; §591; §163; §265; §595; §594; §61(a); §165(c) and (1); §584(a)-(d),(h).

Treasury Regulations:

§ 1.581-1; § 301.7701-13A; § 1.585-2(e)(2)(ii); § 1.165-4; § 1.166-2; § 1.166-3(a)(2); § 1.585-2; §1.585-5 through -8; § 1.593-I1; Prop. Treas. Reg. § 1.593-12 to-14; § 1.166-6; § 1.584-4(a)-(b).

Examples: 1-9.

B. Optional Reading

Cases:

U.S. v. Seattle First Int'l Corp., 79-2 U.S.T.C. ¶ 9495 (D. Wash. 1979); *Morris Plan Bank of New Haven v. Smith*, 125 F.2d 440 (2d Cir. 1942); *Austin State Bank v. Comm'r*, 57 T.C. 1880 (1973); *Barnett Banks, Inc. v. Commissioner*, 83 T.C.M. (CCH) 16 (2002); *Cottage Savings Ass'n v. Comm'r*, 499 U.S. 554 (1991); *Community Trust Bancorp v. U.S.*, 1999-2 USTC ¶ 50,698; *Bell Federal Savings and Loan Ass'n v. Comm'r,* 40 F.3d 224 (7th Cir. 1994); *Midwest Sav. Ass'n v. Comm'r*, 75 T.C. 262 (1980); *Community Bank v. Comm'r*, 819 F.2d 940 (9th Cir. 1987); *Gibraltar Financial Corp. of California v. U.S.*, 825 F.2d 1568 (Fed. Cir. 1987); *PSB Holdings, Inc. v. Comm'r*, 129 T.C. 15 (2007).

Published IRS Guidance:

Rev. Rul. 58-605, 1958-2 C.B. 358; Rev. Rul. 90-54,1990-2 C.B. 270; Rev. Rul. 81-18, 1981-1 C.B. 295, Rev. Rul. 92-14, 1992-1 C.B. 93; Rev. Proc. 92-84, 1992-2 C.B. 489; Rev. Rul. 2001-59, 2001-51 I.R.B. l; Rev. Rul. 55-391, 1955-1 C.B. 306; Rev. Proc. 70-20, 1970-2 C.B. 499; Rev. Rul. 90-44, 1990-1 C.B. 54; Notice 2003-54, 2003-33 I.R.B. 363.

Informal IRS Guidance:

LTR 7921016 (Feb. 12, 1979); LTR 8928002 (Mar. 22, 1989); LTR 9423002 (Jan. 25, 1994); LTR 8425059 (Mar. 20, 1984); LTR 8544030 (July 31, 1985); LTR 8929061 (Apr. 26, 1989).

Legislative History:

Staff of the Jt. Comm. on Taxation, General Explanation of the Tax Reform Act of 1986 ("1986 Act Bluebook") 549-574; Staff of the Jt. Comm. on Taxation, General Explanation of Tax Legislation Enacted in the 104th Congress ("1996 Act Bluebook") 195-196, 247-256.

Other:

Wakely et al., Federal Income Taxation of Banks and Financial Institutions (5th ed.).

Peat, Marwick, Mitchell & Co., Taxation of Financial Institutions.

RIA, Federal Tax Coordinator 2d, Volume 8, Paragraphs E-3000 to E-3800.

II. TAXATION OF RICS, REITS, REMICS, AND FASITS

A. RICs

1. Required Reading

Code Sections:

§851; §584(a); §852; §243; §4982; §855; §860; §561; §562(c), §265(a)(3); §854(b); §67(c); §853.

Treasury Regulations:

§ 1.851-1; § 1.851-5; § 1.852-11; § 1.852-4.

Examples: 10-13.

2. Optional Reading

Published IRS Guidance:

Rev. Rul. 88-41, 1988-1 C.B. 253; Rev. Rul. 89-81, 1989-1 C.B. 226; Rev. Proc. 2003-32, 2003-16 I.R.B. 803; IRS Notice 97-64, 1997-2 C.B. 323; Rev. Rul. 92-56, 1992-2 C.B. 153; Rev. Rul. 2003-84, 2003-32 I.R.B. 289; Rev. Rul. 92-89, 1992-2 C.B. 154; Rev. Proc. 2004-28, 2004-22 I.R.B. 984; Rev. Proc. 2009-42, 2009-40 I.R.B. 459.

Informal IRS Guidance:

LTR 8806044 (Nov. 17, 1987); LTR 9006015 (Nov. 8, 1989); LTR 9015011 (Jan. 8, 1990); LTR 9332031 (May 17, 1993).

Other:

GCM 39626 (Apr. 29,1987); IRS Notice 97-64,1997-47 I.R.B. 7; IRS Notice 2004-39, 2004-22 I.R.B. 982.

B. REITs

1. Required Reading

Code Sections:

§856; §857; §859; §858; §357(b)(3)(D); §860; §1221(a)(1); §4981; §4982.

Treasury Regulations:

§ 1.857-6(a).

Examples: 14-17.

2. Optional Reading

Published IRS Guidance:

Rev. Rul. 89-130,1989-2 C.B. 117; Rev. Rul. 2004-24, 2004-10 I.R.B. 550; Rev. Rul. 2003-86, 2003-32 I.R.B. 290; Rev. Proc. 2003-65, 2003-32 I.R.B. 336; Rev. Rul. 2002-38, 2002-26 I.R.B. 4.

Informal IRS Guidance:

LTR 9013043 (Dec. 28, 1989); LTR 9014022 (Jan. 2, 1990); LTR 9826049 (Apr. 1, 1998); LTR 200236037 (May 10, 2002);. LTR 200225034 (Mar. 21, 2002); LTR 200225033 (Mar. 21, 2002); LTR 200226013 (Mar. 21, 2002).

Other:

IRS Notice 97-64, 1997-47 I.R.B. 7; IRS Notice 2004-39, 2004-22 I.R.B. 982.

C. REMICs

1. Required Reading

Code Sections:

§860D; §860B; §860G(a)-(d); §860C; §856(e); §860F; §1276; §171; §860E; §860A.

Treasury Regulations:

§ 1.860D-1; § 1.860F-2; § 1.860E-2; § 1.860C-2; § 1.860E-1; Treas. Reg. § 1.446-6.

2. Optional Reading:

Published IRS Guidance:

Rev. Proc. 2004-30, 2004-21 I.R.B. 950; Rev. Proc. 2009-23, 2009-17 I.R.B. 884; Rev. Proc. 2009-45, 2009-40 I.R.B. 471.

Informal IRS Guidance:

LTR 9033008 (May 17, 1990).

Other:

IRS Notice 87-41, 1987-1 C.B. 500; IRS Notice 87-67, 1987-2 C.B. 377; Notice of Proposed Rulemaking, 2004 Fed (CCH) ¶ 49,610 (Aug. 25, 2004); IRS News Release 2004-97, 2004 I.R.B. LEXIS 324 (July 26, 2004).

D. FASITs

E. LEGISLATIVE HISTORY OF RICS, REITs REMICs AND FASITs

1. Staff of the Jt. Comm. on Taxation, General Explanation of the Tax Reform Act of 1986 (“1986 Act Bluebook”) 375-383, 384401, and 402-428.

2. Senate Finance Committee Report on the Technical Corrections Act of 1988 (S. 2238), S. Rep. No. 445, 100th Cong., 2d Sess. 92-109(1988).

3. Staff of the Jt. Comm. on Taxation, General Explanation of Tax Legislation Enacted in the 104th Congress (“1996 Act Bluebook”) 258-266.

4. Staff of the Jt. Comm. on Taxation, General Explanation of Tax Legislation Enacted in 1997 (“1997 Blue Book”) 382-393.

F. OTHER MATERIALS

1. Tax Management, Tax Practice Series, Chapters on RICs, REITs and REMICs

2. Mertens, Law of Federal Income Taxation, Volume 10, Chapters 41 (RICs), 41A (REITs) and 40A (REMICs and FASITs).

3. RIA, Federal Tax Coordinator 2d, Volume 8, Sections E- 6000 to E-6300 (RICs), E-6500 to E-6850 (REITs), E-6900 to E-7200 (REMICs); and E-7300-7400 (FASITs).

4. RIA, Tax Advisors Planning Series, Regulated Investment Companies (1997).

5. Tax Management Portfolio No. 107-5th, Real Estate Investment Trusts.

6. Tax Management Portfolio No. 117-2d, REMICs and Other Mortgage-Backed Securities.

7. Humphreys et. al., Mortgage-Backed Securities Including REMICs and Other Investment Vehicles (Little, Brown 1995).

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

A. Required Reading

Code Sections:

§461(h); §816; §832; §831; §501(c)(15); §834; §812(c)-(d); §848; §846; §847; §264(f); §501(m); §833.

Treasury Regulations:

§ 1.832-4; § 1.846-1 through § 1.846-3; Treas. Reg. § 1.832-4.

Examples: 18-22.

B. Optional Reading

Cases:

AAA v. U.S., 367 U.S. 687 (1961); *RCA Corp. v. U.S.*, 664 F.2d 881 (2d Cir. 1981); *Bituminous Casualty Corp. v. Comm'r*, 57 T.C. 58 (1971); *Sears, Roebuck & Co. v. Comm'r*, 96 T.C. 61 (1991), *rev'd*, 972 F.2d 858 (7th Cir. 1992); *AIG, Inc. v. U.S.*, 38 Fed. Cl. 272 (1997); *Utah Medical Ins. Ass'n v. Comm'r*, 76 TCM (CCH) 1100 (1998); *Minnesota Lawyers Mutual Ins. Co. v. Comm'r*, 79 TCM (CCH) 2234, *aff'd*, 285 F.3d 1086 (8th Cir. 2002); Home Group, Inc. v. Comm'r, 89-1 U.S.T.C. ¶ 9329 (2d Cir. 1989); *Allstate Ins. Co. v. U.S.*, 936 F.2d 1271 (Fed. Cir. 1991); *Western Nat'l Mutual Ins. Co. v. Comm'r*, 102 T.C. 338 (1994), *aff'd*, 65 F.3d 90 (8th Cir. 1995); *Atlantic Mutual Ins. Co. v. Comm'r*, 98-1 U,S.T.C. ¶ 50,341 (1998), *aff'd*, 111 F.3d 1056, aff'd, 523 U.S. 382 (1998); *Blue Cross & Blue Shield of Texas v. Comm'r*, 115 T.C. 148 (2000); *Trigon Insurance Co. v. U.S.*, 215 F. Supp.2d 687 (E.D.Va. 2002); *Highmark, Inc. v. U.S.*, 78 Fed. Cl. 146 (2007).

Published IRS Guidance:

Rev. Rul. 83-174, 1983-2 C.B. 108, obsoleted by Rev. Rul. 91-22, 1991-1 C .B. 91; Rev. Rul. 68-27, 1968-1 C.B. 315; Rev. Proc. 2002-46, 2002-28 I.R.B. l; 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; Rev. Proc. 92-72, 1992-2 C,B. 439; Rev. Proc. 2004-10, 2004-2 I.R.B. 288; Rev. Proc. 92-77, 19922 C.B. 454; IRS Notice 2000-34, 2000-33 I.R.B. 1; IRS Notice 2004-64, 2004-41 I.R.B. 598.

Informal IRS Guidance:

LTR 8817001 (July 28, 1987); LTR 9412002 (Dec. 17, 1993); FSA 200104011 (Oct. 19, 2000); LTR 200028018 (Apr. 14, 2000); LTR 200042018 (July 21, 2000); LTR 200140057 (July 9, 2001); LTR 200242027 (July 17, 2002); LTR 200044028 (Aug. 7, 2000); LTR 200116041 (Jan. 24, 2001); LTR 9647002 (July 29, 1996); LTR 9648002 (Aug. 2,1996); LTR 9811041 (Dec. 11, 1997); 9228003 (Mar. 26,1992); IRS CCA 200234013 (May 9, 2002); LTR 9516001 (Dec. 8, 1994); TAM 200006007 (Sept. 2, 1999); LTR 9732004 (Apr. 30, 1997).

Legislative History:

Staff of the Jt. Comm. on Taxation, General Explanation of the Tax Reform Act of 1986 ("1986 Act Bluebook") 594-623.

Other Materials:

KPMG, Federal Taxation of Insurance Companies (RIA 1998), Chapters 12-15.

Mertens, Law of Federal Income Taxation, Volume 11, Section 44.

RIA, Federal Tax Coordinator 2d, Volume 8, Sections E-5500 to E-5700.

Male, "Unearned" or Merely Inexplicable?: The Federal Tax Treatment of Retrospective Rate Credits by Property and Casualty Insurance Companies, 98 Tax Notes 104-94 (1998).

IV. TAXATION OF LIFE INSURANCE COMPANIES

A. Required Reading

Code Sections:

§7702; §816; §801; §815; §803 §807; §809; §810(a); §812; §804; §805; §806; §808; §264(f); §481; §848; §845(a)-(b).

Treasury Regulations:

§ 1.807-1; Prop. Treas. Reg. § 1.801-4(g); § 1.809-10; § 1.848-1; § 1.8482.

Examples: 23-26.

B. Optional Reading

Cases:

Bankers Life & Casualty Co. v. U.S., 98-1 U.S.T.C. ¶ 50,346 (7th Cir. 1998); *National Life Ins. Co. v. Comm'r*, 103 T.C. No. 615 (1994), *aff'd*, 103 F.3d 5 (2d Cir. 1996); *UNUM Life Ins. Co. v. U.S.*, 929 F. Supp. 15 (D. Me. 1996), *aff'd*, 130 F.3d 501 (1st Cir. 1997); *American Mutual Life Ins. Co. v. U.S.*, 43 F.3d 1172 (8th Cir. 1994), *cert. denied*, 516 U.S. 930 (1995); *Indianapolis Life Ins. Co. v. U.S.*, 115 F.3d 430 (7th Cir. 1997), *aff'g* 940 F. Supp. 1370 (S.D. Ind. 1996); *CUNA Mutual Life Ins. Co. v. U S.*, 97-2 U.S.T.C. ¶ 50,904 (Fed. Cl. 1997); *John Hancock Financial Services, Inc. v. U.S.*, 378 F.3d 1302 (Fed. Cir. 2004); *Pan American Life Ins. Co. v. U.S.*, 97-2 U.S.T.C. ¶ 50,655 (E.D. La. 1997); *Trans City Life Ins. Co. v. Comm'r*, 106 T.C. 274 (1996), nonacq., 1998-1 I.R.B. 5; *New York Life Insurance Co. v. U.S.*, 2011-1 U.S.T.C. ¶ 50373 (S.D.N.Y. 2011).

Published IRS Guidance:

Rev. Rul. 83-132,1983-2 C.B. 270; Rev. Rul. 94-45, 1994-2 C.B. 39; Rev. Rul. 92-19, 1992-1 C.B. 227; Rev. Rul. 2004-14, 2004-8 I.R.B. 511; Rev. Rul. 94-74, 1994-2 C.B. 157; Rev. Rul. 2002-6, 2002-6 I.R.B. 460; Notice 2002-33, 2002-21 I.R.B. 989; Rev. Rul. 89-106, 1989-2 C.B. 108.

Informal IRS Guidance:

LTR 9224001 (Feb. 12, 1992); LTR 9452001 (Aug. 26, 1994); LTR 9620001 (Jan. 23, 1996); LTR 9442001 (June 7, 1994); LTR 9745013 (Aug. 7, 1997); LTR 9623005 (Feb. 22, 1996); IRS CCA 200220006 (Feb. 5, 2002); TAM 200948042 (Nov. 27, 2009).

Legislative History:

Staff of the Jt. Comm. on Taxation, General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984 ("1984 Act Bluebook") 572-665; Staff of the Jt. Comm. on Taxation, General Explanation of the Tax Reform Act of 1986 ("1986 Act Bluebook") 582-593; H.R. Rep. No. 964, 101st Cong., 2d Sess. at 1063-72 (1990)("1990 Act Conference Report").

Other:

IRS Notice 88-106, 1988-2 C.B. 444.

Peat, Marwick, Mitchell & Co., Federal Taxation of Insurance Companies (P-H).

Mertens, Law of Federal Income Taxation, Volume 11, Section 44A.

Emanuel Burstein, Federal Income Taxation of Insurance Companies (2d Ed.).

RIA, Federal Tax Coordinator 2d, Volume 8, Sections E-4800 to E-5400.

V. TAXATION OF INSURANCE PRODUCTS

A. Required Reading

Code Sections:

§101(a)-(g); §7702; §262; §162; §264; §62; §79(a)-(b); §163; §265(f); §291; §72(e), (u), and (v); §7702A; §7702B; §72(b)(1)-(3),(c)(1)-(3),(e),(q), and (s); §213(d)(10); §104; §817; §817A; §61; §1001; §1035; §1031.

Treasury Regulations:

§ 1.817-5(a),(b),(f).

Examples: 27-33.

B. Optional Reading

Cases:

Winn-Dixie Stores, Inc. v. Comm'r, 113 T.C. 254, *aff'd*, 254 F.3d 1313 (11th Cir.), *cert. denied*, 122 S. Ct. 1537 (2002); *IRS v. CM Holdings*, 254 B.R. 578 (D. Del.), *aff d*, 301 F.3d 96 (3d Cir. 2002); *American Electric Power, Inc. v. U.S.*, 136 F. Supp.2d 762 (S.D. Ohio 2001), *aff'd*, 326 F.3d 731 (6th Cir. 2003); *Dow Chemical Co. and Subsidiaries v. United States*, 250 F. Supp. 2d 748 (E.D. Mich. 2003); *Addis v. Commissioner*, 2004-2 U.S.T.C. ¶ 50, 291 (9th Cir.); *Conway v. Comm'r*, 111 T.C. 350 (1998), *acq.*, 1999-47 I.R.B. 573.

Published IRS Guidance:

Notice 2008-92, 2008-43 I.R.B. 1001; Rev. Proc. 2001-42, 2001-36 I.R.B. 212; Rev. Rul. 64-328, 1964-2 C.B. 11; Rev. Rul. 67-154, 1967-1 C.B. 11; Rev. Rul. 66-110, 1966-1 C.B. 12; Notice 2001-10,2001-5 I.R.B. 459; Notice 2002-8, 2002-4 I.R.B. 398; Notice 2002-59, 2002-36 I.R.B. 481; Rev. Proc. 2001-13, 2001-3 I.R.B. 337; Rev. Rul. 95-53, 1995-2 C.B. 30; Rev. Rul. 2003-91, 2003-33 I.R.B. 347; Rev. Rul. 2003-92, 2003-33 I.R.B. 350; Notice 2000-9, 2000-1 C.B. 449; Rev. Rul. 73-67, 1973-1 C.B. 330; Rev. Rul. 97-46, 1997-46 I.R.B. 7; Rev. Rul. 2002-75, 2002-45 I.R.B. 812; Rev. Rul. 2003-76, 2003-33 I.R.B. 355; Rev. Rul. 90-109,1990-2 C.B. 191; Rev. Rul. 72-358,1972-2 C.1$. 473; Rev. Rul. 85-159, 1985-2 C.B. 29; Rev. Rul. 92-43, 1992-1 C.B. 288; Rev. Proc. 92-44 (as amended by 92-44A), 1992-1 C.B. 875.

Informal IRS Guidance:

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); TAM 200213010 (Dec. 11, 2001); LTR 9604001 (Sept. 8, 1995); LTR 9812005 (Jan. 22, 1998); LTR 9322011 (Mar. 5, 1993); LTR 9316018 (Jan. 22, 1993); LTR 9120024 (Feb. 20, 1991); LTR 200244001 (May 2, 2002); LTR 9542037 (July 21, 1995); LTR 8310033 (Dec. 3, 1982); LTR 9708016 (Nov. 20, 1996); LTR 200243047 (July 30, 2002); LTR 9644016 (July 18, 1996).

Treasury Regulations:

Treas. Reg. §§ 1.61-22; 1.7872-15.
Prop. Treas. Reg. § 1.61-22; Prop. Treas. Reg. § 1.1402(a)-18; Prop. Treas. Reg. § 1.7872-15.

Legislative History:

Staff of the Jt. Comm. on Taxation, General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984 ("1984 Act Bluebook") 645-665; Staff of the Jt. Comm. on Taxation, General Explanation of the Tax Reform Act of 1986 ("1986 Act Bluebook") 575-581; Staff of the Jt. Comm. on Taxation, General Explanation of Tax Legislation Enacted in the 104th Congress ("1996 Act Bluebook") 235-239.

Other:

Tax Management, Tax Practice Series, Chapter on Section 1035 Exchanges of Insurance Contracts.

Bittker, Federal Taxation of Income Estates and Gifts, Chapter 12.

Pike, Reflections on the Meaning of Life; An Analysis of Section 7702 and the Taxation of Cash Value Life Insurance, 43 Tax Law Rev. 491 (1989).

VI. OTHER INSURANCE TOPICS

A. Required Reading

Code Sections:

§165(a); §461(f),(h); §951; §953(c)-(d); §4371.

Treasury Regulations:

§ 1.162-1(a); § 1.165-1(a); § 1.461-1(a)(2).

B. Optional Reading

Cases:

Supermarkets General Corp. v. U.S., 537 F. Supp. 759 (D.N.J. 1982); *Kaiser Steel Corp. v. U.S.*, 717 F.2d 1304 (9th Cir. 1983); *U.S. v. Hughes Properties Inc.*, 476 U.S. 593 (1986); *Lukens Steel Co. v. Comm'r*, 442 F. d 1131 (3d Cir. 1971); *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); *Spring Canyon Coal Co. v. Comm'r*, 43 F.2d 78 (10th Cir. 1930), *cert. denied*, 284 U.S. 654 (1930); *Steere Tank Lines, Inc. v. U.S.*, 577 F.2d 279 (5th Cir. 1978), *cert. denied*, 440 U.S. 946 (1979); *Black Hills Corp. v. Comm'r*, 73 F.3d 799 (8th Cir. 1996); *Kidde Industries Inc. v. U.S.*, 98-1 U.S.T.C. ¶ 50,162 (Fed. Cl. 1998); *Clougherty Packing Co. v. Comm'r*, 811 F.2d 1297 (9th Cir. 1987); *Humana, Inc. v. Comm'r*, 881 F.2d 247 (6th Cir. 1989); *Malone & Hyde v. Comm'r*, 95-2 U.S.T.C. ¶ 50, 450 (6th Cir. 1995); *United Parcel Service v. Comm'r*, 254 F.3d 1014 (11th Cir. 2001), *rev'g* T.C. Memo. 1999-268; *Gulf Oil Corp. v. Comm'r*, 89 T.C. 1010, *aff'd*, 914 F.2d 396; *Sears, Roebuck & Co. v. Comm'r*, 96 T.C. 61 (1991), *aff'd*, 92-2 U.S.T.C. ¶ 50, 426 (7th Cir. 1992); *AMERCO v. Comm'r*, 96 T.C. 18 (1991), *aff'd*, 92-2 U.S.T.C. ¶ 50, 571 (9th Cir. 1992); *Harper Group v. Comm'r*, 96 T.C. 45 (1991), *aff'd*, 92-2 U.S.T.C. ¶ 50,572 (9th Cir. 1992); *Ocean Drilling v. U.S.*, 92-1 U.S.T.C. ¶ 50,018 (Cl. Ct. 1991); *Crawford Fitting Co. v. U.S.*, 606 F. Supp. 136 (N.D. Ohio 19185); *U.S. v. I.B.M.*, 517 U.S. 843 (1996); *Home Warranty Corp. v. Elliott*, 585 F. Supp. 443 (D. Del. 1984).

Published IRS Guidance:

Rev. Rul. 89-96, 1989-2 C.B. 114; Rev. Proc. 2002-75, 2002-52 I.R.B. 9917; Rev. Rul. 77-316, 1977-2 C.B. 53; . Notice 2002-70, 2002-44 I.R.B. 1; IRS Notice 2004-65, 2004-41 I.R.B. 599; Rev. Rul. 88-72,1988-2 C.B. 31; Rev. Rul. 2001-31, 2001-25 I.R.B. 1; Rev. Rul. 2002-89, 2002-52 I.R.B. 984; Rev. Rul. 2002-90, 2002-52 I.R.B. 985; Rev. Rul. 78-338, 1918-2 C.B. 107; Rev. Rul. 80-120,1980-1 C.B. 41; Rev. Rul. 2002-91, 2002-52 I.R.B. 991; Rev. Rul. 2008-8, 2008-5 I.R.B. 340; Notice 2008-19, 2008-5 I.R.B. 366.

Informal IRS Guidance:

LTR 8637003 (May 23, 1986); LTR 8638003 (June 11, 1986); LTR 8111087 (Dec. 18, 1980); LTR 9629021 (Apr. 23, 1996); LTR 9623009 (Feb. 29, 1996); LTR 9618024 (Feb. 5, 1996); LTR 8405034 (Oct. 31, 19'83); LTR 8032087 (May 15, 1980); FSA 200209017 (Nov. 26, 2001); F8A 200029010 (Apr. 24, 2000); FSA 200043012 (June 19, 2000); FSA 200105014 (Oct. 26, 2000); FSA 200027008 (Mar. 31, 2000); OM 19167 (Sept. 28,1979); GCM 39795 (Apr. 15,1982); GCM 35796 (May 1, 19174); GCM 38-136 (Oct. 12, 1979); GCM 39247 (June 27, 1984).

Other:

Product Liability Risk Retention Act of 1981, 15 U.S.C. §§3901-3904. IRS Notice 96-37, 1996-2 C.B. 208.

KPMG Peat Marwick, Federal Taxation of Insurance Companies, (RIA 1998), Chapter 25.

VII. COMPARISON OF FINANCIAL INSTITUTIONS

A. Suggested Reading

Clark, The Federal Income Taxation of Financial Intermediaries, 84 Yale Law Journal 1603 (1975).

Neubig, The Taxation of Financial Institutions After Deregulation, 37 National Tax Journal 351 (1984).

Neubig and Steuerle, The Taxation of Income Flowing Through Financial Institutions: General Framework and Summate of Tax Issues, Office of Tax Analysis, Treasury Department, OTA Paper 52 (Sept. 1983).

Treasury Department, Interim Report to the Congress on Life Insurance Company Taxation (June 1988).

Johnson, Common Trends in the Taxation of Banks Thrifts, and Insurance Companies, 67 TAXES 485 (1989).

TAXATION OF COMMERCIAL BANKS AND THRIFT INSTITUTIONS

I. General Considerations

A. Economic Functions of Banks

1. Intermediation between liquid deposits and illiquid investments.

2. Pooling of investments and investment diversity.

B. Types of Bank Organizations

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. National banks can be regulated by the Federal Reserve Board, the Federal Deposit Insurance Corporation, or Comptroller of the Currency and are members of the Federal Reserve System.

3. State-chartered banks are regulated by the state regulatory agency of the state in which they are chartered and may be members of the Federal Reserve.

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).

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, or

(2) Exercising certain fiduciary powers.

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

2. "Receiving Deposits"

a. *U.S. v. Seattle First International Corp.*, 79-2 U.S.T.C. ¶9495 (D. Wash. 1979) (a subsidiary of a bank, which receives no deposits itself, but only cash contributions from its parent, is not a bank because it receives no deposits).

b. *Morris Plan Bank of New Haven v. Smith*, 125 F.2d 440 (2d Cir. 1942) (an entity, not entitled by state law to receive deposits, but that receives "installment payments" on "certificates of indebtedness," receives deposits for purposes of section 581).

c. *Austin State Bank v. Comm'r*, 57 T.C 180 (1973) (Bank received one third of its deposits from related sources, one third from the state government, and one third from the public. The latter two sources are acceptable "deposits" while the first is not).

d. *MoneyGram International*, 144 T.C. No. 1 (2015) (entity's money transfer, money order, and payment processing services did not constitute receiving deposits and making loans).

3. "Making Loans and Discounts"

a. *Austin State Bank v. Comm'r*, 57 T.C. 180 (1973), acq., 1974-1 C.B. 1 (for business reasons only two to four percent of the bank's funds were invested in loans, the remainder was invested in U.S. government securities. That level of loan activity is sufficient.).

4. "Subject by Law to Supervision"

a. Rev. Rul. 58-605, 1958-2 C.B. 358 (insurance company engaged in some banking operations, but was regulated by insurance regulators, not bank regulators, and so was not a bank).

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 each of which must be satisfied. *See* 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. *See* Treas. Reg. § 301.7701-13A(c).

(a) The "savings" test is met if savings are acquired in conformity with rules and regulations of the FHLBB or equivalent state authority. Alternatively, the test is met if more than 75% of the thrift's deposits are received from the general public, and not more than 25% of the thrift's debt consists 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% 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 Assets Test in the "thrift" 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 a "S&L association"). *See also, Barnett Banks, Inc. v. Commissioner,* 83 T.C.M. (CCH) 16 (2002) (domestic building and loan associations that relinquished savings and loan charters and obtained bank charters prior to their acquisition were no longer entitled to use the reserve method of accounting for bad debts under section 593 (since repealed, see below)).

2. Definition of a "Mutual Savings Bank"

a. 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. <u>Taxation of Banks</u>

A. <u>Introduction</u> - 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. Deductions -- 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 (discussed in detail below) --

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 specific charge-off method

a. Specific loans must be determined to be worthless, based on all pertinent evidence. Treas. Reg. § 1.166-2. *See Bank of Kirksville v. U.S.*, 943 F. Supp. 1191 (D.C. Mo. 1996).

b. A partially worthless debt is allowed as a deduction only to the extent it is actually charged off. Treas. Reg. § 1.166-3(a)(2).

c. In the alternative, two unique timing rules are available:

(1) Treas. Reg. § 1.166-2(d)(1) provides that if a bank is ordered by a bank regulator to charge off a loan, or if a bank charges off a loan in accordance with established regulatory authority and that action is confirmed by the regulator on examination or audit, then worthlessness is conclusively presumed to have existed. *See* Rev. Rul. 66-335, 1966-2 C.B. 58, Rev. Rul. 81-18, 1981-1 C.B. 295, and Rev. Rul. 1992-14, 1992-1 C.B. 93. *Credit Life Insurance Co v. U.S.*, 948 F2d 723, (Fed. Cir. 1991).

(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. *See* Rev. Proc. 92-84, 1992-2 C.B. 489, regarding making this election.

(a) In the bank's most recent regulatory examination of the bank's loan review process, the bank's regulator must have made an "express determination" that the bank maintains and applies loan loss classification standards consistent with regulatory standards. Treas. Reg. § 1.166-2(d)(3)(iii)(D).

(b) The election is automatically revoked if the bank does not obtain the required express determination.

(c) The IRS can revoke the election if the bank fails to follow the regulation or if the charge-offs were "substantially in excess of the amount warranted by reasonable business judgment under applicable regulatory standards." *See* Rev. Rul. 2001-59, 2001-2 C.B. 585, 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."

5. Historical Background of the Reserve Method

   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 and reduce the reserve.

   b. 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.

   c. Under the percentage of loans method, 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." The allowable percentage was set by statute, and was phased out over a transition period (from 1.8% to 0.6%). "Eligible loans" were a certain type of "loans," as defined in former section 585(b)(4). *See* Treas. Reg. § 1.585-2(e)(3).

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

   d. After 1987, "large banks" are no longer permitted to use the reserve method and "small banks" may only use the experience method (small banks may no longer use the percentage of loans method).

   e. The experience method does not use statutorily prescribed percentages, but calculates bank-specific percentages.

6. The Experience Method

   a. The experience reserve method 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). *See* LTR 8928002 (Mar. 22, 1989) and LTR 9423002 (Jan. 25, 1994) (interests in mortgage pools constitute "loans").

(1) "Loans" excludes commercial paper held by the bank, debt evidenced by a security, and loans contractually committed but not funded. Treas. Reg. § 1.585-2(e)(2).

(2) REMIC regular interests are "loans."

(3) REMIC and mortgage trust participation certificates were includable in "loans outstanding" for purposes of the bad debt reserve under experience method. Although relatively risk-free loans, they are not excludable from "loans outstanding" unless acquired for purpose of enlarging bad debt deduction. PLR 9423002.

(4) 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).

b. 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. Section 585(b)(2); Treas. Reg. § 1.585-2(c)(i).

c. The maximum allowable 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." Section 585(b)(2); Treas. Reg. § 1.585-2(c)(ii) and (iii).

d. The six-year moving average amount is the amount which bears the same ratio to current loans outstanding as (1) the total of 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. Section 585(b)(2)(A).

(1) Thus, the six year moving average amount equals loans outstanding at the close of the taxable year times the fraction (total bad debts sustained for the current year and the preceding five years / total loans outstanding at the close of those same six years).

(2) 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. Section 585(b)(2)(B).

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

f. *See* Examples #1 and #2.

7. Changes from the specific-charge off method to the reserve method

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

8. 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)(1). *See* Treas. Reg. § 1.585-5 through -8.

(1) Some banks were “large banks” in 1987. Banks that were not “large banks” in 1987 can become “large banks” in a subsequent year.

b. Definition of a “large bank”

(1) A “large bank” is a bank with assets the aggregate adjusted basis of which exceed $500 million. *See* Section 585(c)(2); 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 must use the specific charge-off method. Section 585(c)(3). *See* Treas. Reg. § 1.585-6.

(2) The balance of the bad debt reserve as of the close of the preceding year (Treas. Reg. § 1.585-6(b)(3)) is brought into income over a four-year spread period:

Year 1 – 10%
Year 2 – 20%
Year 3 – 30%
Year 4 – 40%

(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. Treas. Reg. § 1.585-6(b)(2).

(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% of its equity capital (assets less liabilities). Recapture is merely suspended, and restarts when the bank is no longer troubled. Treas. Reg. § 1.585-6(d)(3).

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. Section 585(c)(4).

(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(b).

(a) Pre-disqualification loans are loans held by the bank as of the end of the year that precedes the year in which the bank became a large bank.

(b) Because the reserve covers only pre-disqualification loans, 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.

(c) If in any year the reserve balance exceeds the remaining balance if pre-disqualification loans, the excess reserve amount must be brought into income and the reserve balance must be reduced by that amount. Treas. Reg. § 1.585-7(c).

(d) Once the reserve balance reaches zero, further charge-offs with respect those loans may be charged off under the specific method. Treas. Reg. § 1.585-7(b)(i).

(2) New loans made during the year the bank becomes a large bank and thereafter are accounted for under the specific charge-off method. Treas. Reg. § 1.585-7(a).

f. *See* Example #3.

D. <u>Special Gain and Loss Provisions</u>

1. Worthless Securities

a. Under the generally applicable rules that apply to corporations:

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

(2) But, a special rule applies to "securities." Section 165(g)(1) provides that when a "security" that 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. In lieu of the generally applicable rule, a special rule applies to banks for losses upon worthlessness of section 165(g)(2)(C) debt "securities":

(1) 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.

(2) Thus, the usual section 166(a) and 166(b) rules govern the bad debt deduction.

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

c. 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.

(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.

2. Worthless Stock

a. Rules generally applicable to corporations:

(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% owned domestic corporations, 90% 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:

(1) Section 582(b) provides that if a bank holds at least 80% of stock in another bank, that stock will not be treated as a capital asset (there is no 90% income test).

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(b) provides that if a bank is required by regulators to charge off stock as worthless, 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 even though 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. This special treatment was repealed by the 1969 Tax Reform Act. A transitional rule providing grandfather relief, section 582(c)(2) to (4), was repealed by the 1990 Act.

V. <u>Taxation of Thrift Institutions</u>

A. Recall that section 581 provides that a thrift is a "bank."

B. <u>Reserves for Losses on Loans</u>

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

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

b. Thrifts may be able use the reserve method.

(1) If a thrift is treated as a "large bank," it must use the specific charge-off method, starting in 1996 or any subsequent year when it becomes a large bank.

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

2. Historical Background

a. Through 1995, a thrift had three reserves:

(1) The reserve for losses on "qualifying real property loans" (the "Q" reserve), which were loans secured by an interest in improved real property. The Q reserve was computed using the "percentage of taxable income method" or experience method.

(2) The reserve for losses on "nonqualifying loans," which were all loans that were not qualifying real property loans (the "non-Q" reserve). The non-Q reserve addition was separately computed under the experience method.

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

(4) In the 1996 Small Business Act, section 593 was repealed, effective for years after 1995. Section 593(f).

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

a. If, in 1996, the thrift was as a "large bank," it was required to use the specific charge-off method.

b. If, in 1996, the thrift was not a large bank, it could utilize the reserve method for losses on loans, but was not permitted to use the percentage of taxable income method, but was required to use the section 585 experience method.

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

   a. 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).

      (1) 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.

      (2) 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.)

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

      (4) The portion of bad debt reserves not granted a "fresh start," i.e., the portion attributable to post-1987 reserve additions, is called the "applicable excess reserves" (section 593(g)(2)) and must be brought into income ratably over 6 years. Section 593(g)(1)(C).

5. Rules applicable to a thrift that was treated as a "large bank" in 1996 and began in 1996 to use the specific charge-off method.

   a. The "applicable excess reserves" (the portion of the bad debt reserves attributable to post-1987 reserve additions) must be brought into income ratably over a six-year period beginning with 1996. Section 593(g)(1)(C).

      (1) Generally, the applicable excess reserves equal the balance of the Q reserves and the non-Q reserves as of year-end 1995 minus the balance of such reserves as of year-end 1987 (the "pre-1988 reserves").

      (2) Two special rules potentially applied to modify this treatment.

         (a) In computing applicable excess reserves, the balance of year-end 1987 reserves was proportionally reduced if the balance of loans outstanding as of year-end 1995 was less than the balance as of year-end 1987. Section 593(g)(2)(A)(ii)(1I).

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

b. After 1996, the pre-1988 reserves remain relevant:

(1) The pre-1988 reserves (and the supplemental reserve) are tax attributes to which section 381 applies.

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

c. *See* Example #4.

6. Rules applicable to a thrift that was <u>not</u> treated as a "large bank" in 1996 and that began in 1996 to use the experience method.

a. In 1996, the thrift was no longer permitted to use the percentage of taxable income reserve method, but could instead begin to use the experience method.

(1) First, the thrift began to use the experience method for 1996. For this purpose, an opening 1996 reserve was required to be established under the experience method. Section 593(g)(2)(B).

(a) This new reserve was the greater of two amounts:

i) Either the actual year-end 1987 balance of reserves (the pre-1998 reserves), or

ii) Reserves computed under section 585(b)(2)(A) (the six-year moving average amount) as of year-end 1995, and as if the experience method had been used for all prior tax years.

(b) For the ongoing use of the experience method, the "base year reserves" are balance of the pre-1988 reserves.

(2) Second, and the amount of the otherwise required section 481 adjustment was modified. Section 593(g)(2)(B).

(a) "Applicable excess reserves" were computed as the balance of the Q reserves and the non-Q reserves as of year-end 1995 minus the greater of (i) such reserves as of year-end 1987 (the "pre-1988 reserves") or (ii) the opening 1996 reserve computed under the experience method (see (1) immediately above).

(b) Thus, the section 481 adjustment was reduced by any excess of the opening 1996 experience reserve balance over the pre-1988 reserves.

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

b. After 1996, the pre-1988 reserves remain relevant:

(1) The pre-1988 reserves (and the supplemental reserve) are tax attributes to which section 381 applies.

(2) After 1996, the pre-1988 reserves also remain relevant if the thrift subsequently becomes a "large bank."

(a) 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) Ordinarily, if the thrift becomes a large bank uses the section 585(c)(3) recapture method, the section 481 adjustment would be the preceding year-end balance of the reserves. But, under the recapture method, the 481 adjustment is only the prior year-end reserve balance minus the pre-1988 reserve.

(c) Similarly, if the thrift elects the section 585(c)(4) cut-off method, the prior year-end reserve balance (against which "pre-disqualification loans" must be charged) also is reduced by pre-1988 reserves.

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

c. *See* Example #5.

7. After 1995, if a thrift makes a distribution that is not deductible under section 591(a), and if the thrift has a balance of pre-1988 reserves, a special rule applies to distributions to shareholders. Section 593(e).

a. 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, second out of pre-1988 reserves, and third out of the supplemental reserve.

b. Distributions in excess of E&P and out of the reserves for losses on loans (after being grossed-up for taxes) are charged against those reserves and are included in the thrift's gross income.

c. Section 593(e) continues to apply whether the thrift remains a thrift or becomes a commercial bank. If the thrift is merged or liquidated tax-free into a bank the pre-1988 reserve will not be restored to income. Instead, the bank will acquire the thrift's E&P and pre-1988 reserves and section 593(e) will apply to the bank as if it was a thrift. (Conference Report 104-737)

C. <u>Deduction for Dividends on Deposits</u>

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

a. 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 Say. Ass'n v. Comm'r*, 75 T.C. 262 (1980).

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

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

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

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 and to establish a link between the borrowing and the acquisition of the tax-exempt obligations.

1. 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.

C. 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.

D. 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%. The percentage was subsequently increased to 20%.

2. Financial institution preference items include:

a. 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. Thus, 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%. Section 291(a)(3) and (e).

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

interest allocable to tax exempt obligations total interest deduction	=	adjusted basis of such tax-exempt obligations adjusted basis of all assets

6. *See* Example #6.

E. Proration Under Section 265(b)

1. In the 1986 Act, the former 20% disallowance rule was replaced with a 100% 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)):

interest allocable to tax exempt obligations total interest deduction	=	adjusted basis of such tax-exempt obligations 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% disallowance rule.

6. *See* Example #7.

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

8. *See* Example #8.

VII. Foreclosure on Property Securing Loans

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 (*see* 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. *Community Bank v. Comm'r*, 819 F.2d 940 (9th Cir. 1987).

4. *See* 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. 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.

2. 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% 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. <u>Section 597</u>

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. <u>2007-2008 Recession Developments</u>

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. Ordinarily the IRS will not rule on whether an entity meets the requirements of section 584. Rev. Proc. 2014-3.

D. <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. Merger of 2 common trust funds does not, of itself, result in gain or loss to funds or participants, or in any change in basis of portfolio assets. However, gain or loss may result if cash or other assets are distributed to eliminate fractional units of participation. Rev. Rul. 60-240, 1960-2 C.B. 192.

6. 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. In General

A. Economic functions

1. Pooling of investments

2. Investment diversity

3. Investment advice and management

B. General operation

1. It is intended that:

a. These entities be vehicles for holding passive investments.

b. The entities pass-through most of their income to shareholders.

2. If the requirements designed to achieve these goals are satisfied, then the entities qualify 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*

e. Rev. Rul. 88-41, 1988-1 C.B. 253.

(1) If the RIC is a personal holding company, it is taxed at the highest section 11(b) tax rate.

(2) The RIC also is taxed at the highest rate if it fails to keep the ownership records necessary to determine PHC status. Code Section 582(b)(1).

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. Special entity rules:

(1) Series Funds: A RIC may have multiple funds, i.e., segregated portfolios of assets for which there are separate classes or series of preferred stock. 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).

(2) Unit Investment Trusts: Periodic payment plan investors may invest in a unit investment trust that invests in the securities of the RIC. In this situation, the trust is not a taxable entity and the holders of interests in the trust are treated as owning the RIC securities held by the trust. Code section 851(f).

2. Election of RIC status

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

b. To be able to make the election, the corporation must (i) have been taxed as a RIC for all tax years ending on or after November 8, 1983 (section 851(a)(2)(A)) or (ii) 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, and has earnings while not a RIC, it can distribute non-RIC earnings and profits in order to requalify. Section 852(e).

3. Source of income requirement

a. At least 90% of the corporation's gross income must be qualifying income, which includes:

(1) Dividends, interest, payments with respect to securities loans, gains from the sale of stock or securities or foreign currencies, or other income received with respect to its business if investing in stock, securities or currencies. Section 851(b)(2)(A).

(a) Dividends include deemed dividends from CFCs and passive foreign investment companies under sections 951(a) and 1293(a).

(b) Interest includes original issue discount on short-term obligations and discount on treasury bills. Rev. Rul. 72-225, 1975-1 C.B. 191; Rev. Rul. 75-376, 1975-2 C.B. 267.

(c) Income from foreign currency forward contracts is qualifying income. LTR 200602032. The Treasury is authorized to issue regulations excluding foreign currency gains not directly related to the RIC's principal investing business. Section 851(b).

(d) Income from derivative contracts may (Rev. Rul. 2006-31) or may not (Rev. Rul. 2006-1) constitute qualifying income, depending on the type of contract.

(e) Reimbursements received from the RIC's investment advisor may constitute qualifying income. Rev. Rul. 92-56, 1992-2 C.B. 153.

(2) Generally, income from a partnership or trust is includible in qualifying income only if it would be includible had the RIC received the income directly. Section 851(b). LTR 9847017.

(a) This is often referred to as the "look through" rule.

(3) However, income and gains from qualified publicly traded partnerships (qualified PTPs) also is qualifying income. Section 851(b)(2)(B) (added in the 2004 Jobs Act).

(a) PTPs (also called master limited partnerships or MLPs) are limited partnerships traded on public exchanges. Section 851(h) defines 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). *See* section 7704(b).

(b) Before the 2004 Jobs Act, if a RIC was a unit holder in a PLP the look-through rule would apply. This discouraged RICs from investing in MLPs.

(c) A "qualified PTP" is a PTP that derives less than 90% of its income from interest, dividends, capital gains, and other sources of income that qualify for the 90% income test. Section 851(h). All of a qualified PTP's income is included in the 90% income test.

(d) If a PTP is not "qualified," i.e., 90% or more of its income qualifies for the 90% income test, then the look-through rule applies.

b. For purposes of the 90% gross income test, in calculating gross income:

(1) capital losses are ignored, and

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

c. *See* Example #10

d. Curing a Failure to meet the 90% Gross Income Test

(1) Code section 851(i) provides a mechanism to prevent loss of RIC status in the event of a failure to satisfy the source of income requirement.

(2) A RIC that fails to meet the 90% income test for any taxable year nevertheless 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)

(c) In addition, a tax is paid in an amount equal to the excess of (i) the gross income of such company which does satisfy the 90% income test over (ii) 1/9 of the gross income of such company which does qualify. Section 851(i)(2).

i) For example, if a RIC has $90x of qualifying gross income and $15x of non-qualifying gross income, a $5x tax is imposed.

ii) The tax equals the amount by which the $15x of non-qualifying gross income exceeds the permitted $10x amount (1/9 of $90x).

4. Investment diversification requirements

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

b. <u>First</u>, at least 50% of the corporation's assets must be invested in cash, cash items, government securities, RIC securities, and certain "other 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).

(2) 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.

(3) The RIC can be treated as directly owning the assets held by certain partnerships. For purposes of Code Sec. 851(b)(3), RICs that are consenting partners in eligible

partnerships that invest in tax-exempt are treated as if they directly invested in assets held by eligible partnership. Rev. Proc. 2005-20, 2005-1 CB 990.

(4) For purposes of the 50% test, “other securities” (i.e., securities not issued by the Government or another RIC) do not qualify if:

(a) the value of those securities exceeds 5% of the value of the RIC’s total assets, or

(b) the securities exceed 10% of the issuer’s outstanding voting securities

i) For purposes of this 10% test, equity securities of a qualified PTP are treated as outstanding voting securities. Section 851(c)(5).

(5) Securities acquired by a RIC from a reorganization or antitrust order distribution are included (and counted) in determining compliance with the 5% investment limitation of Code Sec. 851(b)(3)(A). Rev. Rul. 63-170, 1963-2 C.B. 286.

(6) *See* Example #11.

(7) There is an exception to the 50% 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% test, the RIC may include stock even if it holds more than 10% of the stock of the issuer.

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

(c) This special rule ceases to apply if:

i) The special rule will not apply to the securities of an issuer if the RIC has continuously held any security of that issuer for 10 or more years. Section 851(e)(1).

ii) The special rule will not apply to all securities if 25% or more of the value of the RIC's assets consists of (1) securities of issuers with respect to which the RIC holds more than 10% of the outstanding voting securities and (2) the RIC has continuously held any security of each such issuers for 10 or more years. Section 851(e)(2).

(d) *See* Example #12.

c. <u>Second</u>, no more than 25% of the value of the RIC's total assets may be invested in (1) securities (other than government or other RIC securities) of any one issuer, or (2) securities of two or more issuers of which the RIC owns 20% or more of the voting stock and which are in similar or related trades or businesses, or (3) securities of one or more 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 a member of "controlled group" of corporations if the RIC controls at least one member of the controlled group. "Control" means ownership of 20% of the voting stock of a corporation. Section 851(c).

(a) A safe harbor is provided to allow a RIC that invests in one or more other RICs to satisfy 25% asset test. Rev. Rul. 2015-45.

i) A Fund of Funds is a structure composed of a RIC (Upper RIC) that invests in stock (and possibly other securities) of one or more other RICs (Lower RICs). The Upper RIC and Lower RICs generally are members of the same fund family.

ii) Applying the "proper proportion" rule, investments of the Lower RIC might cause the Upper RIC to violate the 25% asset test.

iii) Under the safe harbor, the investments of the Lower RIC will not cause the Upper RIC to violate the 25% asset test if the Lower RIC satisfies that test.

(2) Securities acquired by a RIC from a reorganization or antitrust order distribution are included (and counted) in determining compliance with the 25% investment

limitation of Code Sec. 851(b)(3)(B). Rev. Rul. 63-170, 1963-2 C.B. 286.

(3) *See* Example #13.

d. The 50% and 25% investment diversification tests must be satisfied quarterly. Section 851(d)(1).

(1) A RIC will lose RIC tax status by failing to meet either asset test only if the failure occurs after the acquisition of a security or other property and the failure is the result of that acquisition.

(a) 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. Treas. Reg. § 1.851-5, Example (6).

(b) Also, if a RIC satisfies the tests for one quarter, and then, due solely to a distribution of cash, fails to meet one of the tests in the next quarter, it retains RIC status. Treas. Reg. § 1.851-5, Example (5).

(2) If a RIC fails to meet either test after the acquisition of a security or other property, it will not lose RIC tax status if the discrepancy is eliminated within 30 days after the close of the quarter.

e. In situations where the exception in section 851(d)(1) does not apply to cure a failure, section 851(d)(2) provides two special rules available to cure failures to satisfy the two investment diversification tests.

(1) <u>Reasonable Cause Cure</u>: A RIC that fails to meet the investment diversification tests (other than a *de minimis* failure, below) is considered to satisfy the tests for such quarter if (i) a description of each asset causing the failure is filed on a schedule, (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 if 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 this 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).

(c) For purposes of the deficiency procedures, this tax is treated as an excise tax.

(2) *De Minimis* Cure: 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 (a) 1% of the total value of the corporation's assets at the end of the quarter, or (b) $10,000,000, and (ii) the RIC disposes of the assets causing the failure (or if 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).

(a) No tax is due.

f. 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. 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% of its gross "investment company taxable income" (ICTI), plus

(a) This is gross ICTI because dividends paid are not taken into account for this purpose.

(b) Again, ICTI excludes net capital gain.

(2) 90% 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, 1989-1 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. Section 852(a).

d. In order to meet these distribution 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 (i) declares a dividend on or before the later of the 15th day of the 9th month following the close of the taxable year (or the extended tax return due date) and (ii) distributes the dividend within 12 months of the taxable 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.

(3) Section 860 allows for the deduction of deficiency dividends. These are dividends that are paid after an IRS adjustment to taxable income for a year.

B. Taxation of RICs

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% 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)

      (1) ICTI is taxable income, (i) excluding net capital gain, (ii) excluding amounts of ordinary, taxable income distributed to shareholders and eligible for the section 561 deduction for dividends paid, (iii) excluding an amount equal to the tax imposed by sections 851(d)(2) and 851(i), and (iv) excluding certain other adjustments. Section 852(b)(1), (2) and (8).

      (2) Briefly, and in general, ICTI thus is comprised of retained, taxable, ordinary income.

      (3) 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.

      (4) 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.

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

      (6) Income or gains from a RIC's interest in a qualified PTP are 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

      (1) The tax is imposed on undistributed net capital gain (*i.e.*, capital gains less capital gain dividends). Section 852(b)(3)(A).

(2) At the RICs election, certain losses incurred after October 31st of the year (a "post-October capital loss") may be excluded in computing net capital gain for the year. Section 852(b)(8). Such losses are treated as arising on the first year of the following taxable year. This rule helps the RIC avoid section 4982 excise taxes.

(a) For example, a RIC with a taxable year ending June 30, 2014, recognizes on May 15, 2014, a $100x long-term capital gain and a $100x short-term capital loss. The RIC may report a $100x capital gain distribution for the year ended June 30, 2014, and elect to treat the $100x short-term capital loss as arising on July 1, 2014.

c. The RIC is not taxed on its tax-exempt interest.

(1) 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% of the excess of (i) 98% of ordinary income for the calendar year, plus 98.2% 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% to 98.2% effective for calendar years beginning after December 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. <u>Taxation of RIC Shareholders</u>

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). *See* IRS Notice 2015-41.

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 nonpublicly 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% of the value of their total assets in tax-exempt obligations may distribute tax-exempt dividends. Section 852(b)(5).

(1) RICs that are consenting partners in eligible partnerships that invest in tax-exempt bonds are treated as if they directly invested in assets held by eligible partnership. Rev. Rul. 2005-20, 2005-1 C.B. 990.

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

c. Tax-exempt dividends must be reported by written statements to shareholders.

d. If the amount of tax-exempt interest reported to shareholders exceeds the RICs actual tax-exempt interest (an "excess reported amount") adjustments are required. Section 852(b)(3)(C).

(1) For example, assume aggregate reported exempt interest dividends are $120x, but actual exempt interest is $100x. The excess reported amount thus is $20x. If the RIC distributed four quarterly exempt interest dividends of $30x each, each must be reduced by $5x ($20x times ($30x / $120x)).

(2) A special rule applies if the RIC has a taxable year that includes two calendar years. The rule is intended to reduce the need for RICs to file amended 1099s and for RIC shareholders to file amended income tax returns for the first calendar year. If the post-December reported amount exceeds the excess reported amount, then only the post-December exempt interest dividends are reduced.

(3) For example, if the RIC in the foregoing example had a June 30 taxable year, the two post-December exempt interest distributions would each be reduced by $10x.

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 elect to 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. To be able to elect this treatment, more than 50% of the value of the RIC's total assets at the close of the year must consist of stock or securities in foreign corporations. Section 853(a).

d. 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).

e. Notice 2016-10 (IRS guidance concerning the appropriate treatment of foreign tax refunds by RICs that made elections under section 853(a) for the years in which the taxes were originally paid)

5. Pass-through treatment for "qualified fund of funds." Section 852(g).

a. In a "fund or funds" structure an upper-tier RIC owns stock in one or more lower-tier RICs. A "qualified fund of funds" is a RIC if at least 50% of the value of its total assets is represented by interests in other RICs.

b. A qualified fund of funds is able to pay tax exempt interest dividends and pass through foreign tax credits to its shareholders without the need to meet the 50% of asset value requirements.

6. 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 reported by written statements to shareholders.

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

   d. If the amount of capital gains reported to shareholders exceeds the RICs actual net capital gain (an "excess reported amount") adjustments are required. Section 852(b)(3)(C).

      (1) For example, assume aggregate reported capital gain dividends are $120x, but actual net capital gains are $100x. The excess reported amount thus is $20x. If the RIC distributed four quarterly capital gain dividends of $30x each, each must be reduced by $5x ($20x times ($30x / $120x)).

      (2) A special rule applies if the RIC has a taxable year that includes two calendar years. The rule is intended to reduce the need for RICs to file amended 1099s and for RIC shareholders to file amended income tax returns for the first calendar year. If the post-December reported amount exceeds the excess reported amount, then only the post-December capital gain dividends are reduced.

      (3) For example, if the RIC in the foregoing example had a June 30 taxable year, the two post-December capital gain distributions would each be reduced by $10x.

   e. 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).

7. 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).[1]

8. If a RIC reports a dividend as a capital gain dividend for a taxable year in written statements furnished to its shareholders, as described in § 852(b)(3)(C), the RIC must also report in these statements the amounts of the dividend that constitute a " 28% rate gain distribution," an "unrecaptured section 1250 gain distribution," a " section 1202 gain distribution," and a " 20% rate gain distribution." Notice 2015-41.

9. Similarly, if a RIC designates an amount as undistributed capital gains for a taxable year in a written notice mailed to its shareholders, as described in § 852(b)(3)(D), the RIC must also designate in the written notice the amounts of the undistributed capital gains that the shareholders must include as a 28% rate gain distribution, an unrecaptured section 1250 gain distribution, a section 1202 gain distribution, or a 20% rate gain distribution. Notice 2015-41.

10. 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.

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

a. There is 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 current law treatment of gain from the exchange of U.S. real property interests by REITs also applies 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).

12. Credits from Tax Credit Bonds

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

a. A RIC can elect to pass through credits on tax credit bonds. Section 853A.

b. Shareholders are treated as if the RIC distributed an amount of money equal to the amount of credits passed through.

13. 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)):

(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.

Steptoe
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TAXATION OF REAL ESTATE INVESTMENT TRUSTS (REITs)

I. 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 corporation, trust, or association:

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

b. which is not a section 582(c)(2) financial institution or an insurance company,

c. managed by one or more trustees or directors,

d. issuing transferable shares or certificates,

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

f. not "closely held."

(1) This determination is made under section 856(h)(1).

(2) Section 856(h) generally incorporates the section 542(a)(2) rule, under which an entity is not closely held if 50% of which are not owned, directly or indirectly, by 5 or fewer individuals. For this purpose, the section 544 attribution rules apply, except there is no partnership attribution. Section 856(h)(1)(B).

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

(4) For purposes of this 5-or-fewer rule, a "look-through" rule applies to section 401(a) pension trusts ("qualified trusts).

(a) Stock held by the qualified trust is treated as held by the beneficiaries of the trust in proportion to their actuarial interests in the trust.

(b) A REIT held "predominantly" by qualified trusts, and that qualifies as a REIT only because of the look-thru rules, is a "pension-held REIT." Section 856(h)(3)(D). A REIT is predominately held if (i) one qualified trust owns more than 25% of the interests in the REIT or (ii) multiple qualified trusts owning more that 10% of the REIT hold in the aggregate more than 50% of the REIT. Section 856(h)(3)(D).

(c) A qualified trust that holds more than 10% of the interests in a pension-held REIT will have unrelated business taxable income. Section 856(h)(3)(C).

g. Section 856 provides when the foregoing requirements must be met:

(1) Section 856(b) provides that the requirements set forth in subsections a through d, above, must be met during the entire taxable year.

(2) Section 856(b) also provides that the requirement set forth in subsection e, above, must be met during at least 335 days of a 12-month year (or a proportional part of a shorter year).

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

h. Recordkeeping Requirements

(1) The REIT must keep records that allow the IRS to ascertain its actual ownership. Section 857(f)(1).

(2) A REIT that, pursuant to 857(f)(1), complies with Treasury regulations that require the REIT to maintain records that allow the IRS to ascertain actual ownership of its shares, but does not know whether it meets the 5-or-fewer rule, is treated as having met that rule. Section 856(k).

(3) If the REIT fails to comply with the recordkeeping requirements by failing to keep records -

(a) The REIT must pay (on notice and demand from the IRS) a $25,000 penalty for each tax year in which the failure occurs. If the failure is due to intentional disregard, the penalty is $50,000. Section 857(f)(2)(A) and (B).

(b) If the IRS asks the REIT to comply with the requirements and the REIT fails to comply the REIT must pay an additional penalty. Section 857(f)(2)(C).

(c) No penalty is imposed if the failure to comply is due to reasonable cause and not to wilful neglect. Section 857(f)(2)(D).

2. Election of REIT status

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

(1) 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.

b. The REIT election may be terminated either for failure to meet the eligibility requirements or voluntarily. Section 856(g)(1) and (2).

c. As a general rule (subject to exceptions), 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).

d. If the REIT election is terminated due to a failure to qualify, the 5-year wait period will not apply if:

(1) The REIT files a tax return, does not fraudulently include incorrect information on the return, and establishes that the failure to comply was due to reasonable cause. Section 856(g)(4).

e. A REIT that has failed to qualify as a REIT (for reasons other than a failure to meet the 95% and 75% gross income tests or both of the asset tests (sections 856(c)(2),(3), and (4)) may 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. Section 856(g)(5).

3. Special REIT subsidiaries

   a. Qualified REIT subsidiaries. Section 856(i).

      (1) A qualified REIT subsidiary is a corporation 100% owned by the REIT (except for a taxable REIT subsidiary).

      (2) The qualified REIT subsidiary is not treated as a separate corporation.

   b. Taxable REIT subsidiaries. Section 856(l)

      (1) A taxable REIT subsidiary is a corporation directly or indirectly owned by the REIT, if both entities elect that the corporation be so treated.

      (2) A taxable REIT subsidiary also is a corporation directly or indirectly owned by a higher tier taxable REIT subsidiary if the higher tier entity owns more than 35% of the value or voting power of the lower tier entity.

4. 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.

   b. The 75% Gross Income Test

      (1) First, at least 75% of the REIT's gross income must be derived from (section 856(c)(3):

         (a) "Rents" from real property,

         (b) "Interest" on loans secured by real property or interests in real property,

         (c) Gain from the sale of (non-inventory) real property,

         (d) REIT dividends,

         (e) Income from "foreclosure property,"

         (f) "Qualified temporary investment income," and

         (g) Gain from the sale of "real estate assets."

i) Section 856(c)(5)(B) provides that real estate assets include “debt instruments issued by publicly offered REITs.” Section 856(c)(3)(H) excludes gain from the sale of “nonqualified publicly offered REIT debt instruments” from income that qualifies for the 75% test.

a) A “nonqualified publicly offered REIT debt instrument” is a debt that would not qualify as a real estate asset but for section 856(c)(5)(B)’s specific inclusion of “debt instruments issued by publicly offered REITs” in real estate assets.

ii) Real estate assets include fee ownership, leaseholds, options to acquire real estate, etc.

iii) Mineral, oil and gas royalty interests are excluded.

(2) “Rents from real property” includes traditional rent.

(a) Income derived by a REIT from tenants under its rental agreements for use of advertising space on qualified outdoor advertising displays qualifies as rents from real property under Code Sec. 856(d). PLR 201522002.

(b) Boat slips at marina leased by taxpayer were real estate assets under Code Sec. 856(c)(4) and rental income from boat slips qualified as “rents from real property” under Code Sec. 856(c). PLR 201310020

(3) “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).

(4) “Rents from real property” excludes amounts determined by reference to the net income or profits of the lessee or other third party. Section 856(d)(2)(A).

(a) In contrast, rent includes amounts based on fixed percentages of gross receipts or sales.

(b) There are two rules that apply when a tenant of a REIT leases the property to a subtenant.

i) If a tenant pays qualifying rent to the REIT, but the tenant subleases the property and receives both qualifying and non-qualifying rents (based on net profits), only a proportionate portion attributable to the non-qualifying rents are excluded from the rental income of the REIT. Section 856(d)(4).

ii) If a tenant pays to the REIT rent based on its net income or profit, and the tenant subleases and receives both qualifying and non-qualifying rents, only a proportionate portion attributable to the non-qualifying rents are excluded from the rental income of the REIT. Section 856(d)(6).

(5) The definition of "rents" also excludes amounts received from certain related entities.

(a) Generally, 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).

(b) Two exceptions to this rule provide for amounts received from a "taxable REIT subsidiary." The exceptions apply if either:

i) <u>Limited Rental Exception</u>: 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) Lodging or Health Care Exception: The property leased to the taxable REIT subsidiary is a "qualified lodging facility" or "qualified health care property" 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). PLR 201429024; PLR 201429017.

(6) 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.

(a) Various exceptions permit some types of fees for services to be treated as qualifying rent.

(b) A 1% *de minimis* rule applies. Under the rule, if the impermissible tenant service income is less than 1%, only that income will be excluded from rents. If the impermissible tenant service income exceeds 1% of all amounts received by the REIT, all such amounts received are excluded from rents. Section 856(d)(7)(B). Rev. Rul. 98-60 (section 856(d)(7)(B) applies on a property-by-property basis).

(c) Another exception provides that 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 services will not be treated as provided by the REIT. Section 856(d)(7)(C)(i). *See also*, Rev. Rul. 2003-86, 2003-32 I.R.B. 290 (services provided by joint venture between taxable REIT subsidiary and third party corporation do not disqualify rents paid to REIT).

(d) An exception also applies to income that would not otherwise qualify as unrelated business taxable income (UBTI) under section 512(b)(3). Section 856(d)(7)(C)(ii).

(e) A final exception applies to "charges for services customarily furnished" in connection with the rental of real property, such as water, heat, trash collection, etc. Section 856(d)(1)(B).

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

(g) Amounts received by a REIT with respect to cross-connectivity services it furnishes will not cause any amounts received from building's tenants to be treated as other than rents from real property under Code Sec. 856(d). PLR 201334033.

(7) "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.

(a) Interest based on a fixed percentage of receipts or sales is not excluded. Section 856(f)(1)(A).

(b) Similar to the rent exceptions contained in sections 856(d)(4) and (6), two other exceptions also apply:

i) If the REIT receives interest from the borrower that is based in whole or in part on net income or profits of any person, only a proportionate part based on net income or profits will be excluded from interest. Section 856(f)(1)(B)

ii) If the REIT receives interest on a mortgage loan based on the borrower's net income or profits, but the debtor receives substantially all its gross income from the mortgaged property from the leasing of the property to tenants, and a portion of the rents received are qualified rents, then the portion of the amount the REIT receives that is based on qualified rents will not be excluded from interest. Section 856(f)(2).

(8) "Foreclosure property" is property acquired in foreclosure or on threat thereof. Section 856(e)(1).

(a) While income from an active trade or business generally does not qualify for purposes of the 75% of income test, income from foreclosure property will qualify.

(b) 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. Section 856(e)(5).

(c) Such property ceases to qualify as foreclosure property after the REIT has held it for 3 years (2 years for qualified health care facilities). If necessary to orderly liquidate the property, the period can be extended up to 6 years. Section 856(e)(2) and (3) and (e)(6).

(d) Property will cease to qualify as foreclosure property if (i) a lease is entered into that produces income that does not qualify under the 75% test, e.g. a net income lease, (ii) specified construction takes place, or (iii) after 90 days, the property is used in a trade or business that is not conducted by an independent contractor. Section 856(e)(4).

(9) "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. The 95% of Gross Income Test

(1) Second, at least 95% of the REIT's gross income must be from the sources specified in the 75% test, plus income from (section 856(c)(2)):

(a) Interest,

(b) Dividends,

(c) Gains from the sale of stock or securities.

d. 75% and 95% Test Special Rules

(1) Special rules are provided for excluding certain income from hedging transactions for purposes of both the 75% and 95% tests. Section 856(c)(5)(G).

(2) Special rules also are provided for timber gains. Section 856(c)(5)(H).

(3) Special rules are provided for foreign currency transactions. Section 856(n). Certain foreign currency gains recognized under Sections 987 or 988 are excluded as non-qualifying income for purposes of both the 75% and 95% tests, and also are excluded from gross income for purposes of those tests. (Changing the result in Rev. Rul. 2007-33)

(4) Also, the IRS is given authority to include or exclude other items of income or gain as qualifying income. Section 856(c)(5)(J)

e. Curing a failure to satisfy the 75% and 95% tests.

(1) A REIT will not lose REIT status if such failure was due to reasonable cause and not willful neglect, and if all income is listed on a schedule to the return. Section 856(c)(6).

(2) In addition, a tax is due on the listed income. The tax is the greater of the failure to meet the 75% test or the failure to meet the 95% failure. Section 857(b)(5).

(3) The tax is equal to the greater of: (1) the excess of 95% of the gross income (other than income from prohibited transactions) of the REIT over the actual amount of that gross income qualifying under the 95% test or (2) the excess of 75% of its gross income (other than income from prohibited transactions) over the actual amount of that gross income qualifying under the 75% test, multiplied by a specified fraction. Section 857(b)(5).

(4) The numerator of that fraction is the real estate investment trust taxable income for the year determined without regard to the dividends paid deduction and the net operating loss deduction (if any) and by excluding any net capital gains. The denominator of the fraction is gross income determined by excluding gross income from prohibited transactions, gross income and gain from

foreclosure property but only to the extent such income and gain doesn't otherwise satisfy the 75% test, long term capital gain, and short term capital gain to the extent of any short term capital loss. Section 857(b)(5).

f. *See* Example #14

5. Investment diversification requirements

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

b. <u>First</u>, at least 75% 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).

(1) "Real estate assets" include "interests in real property," interests in mortgages, REIT stock, "debt instruments issued by publicly offered REITs," and property attributable to "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).

(b) "Interests in real property" include fee ownership, leaseholds and options, but excludes mineral, oil, and gas interests. Section 856(c)(5)(C).

(c) 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).

(2) Assets are not disqualified by reason of being in a foreign location. Rev. Rul. 74-191.

(3) Cash can include foreign currency in some circumstances. Section 856(c)(5)(K).

c. <u>Second</u>, not more than 25% of the value of total assets can consist of securities, other than government securities acceptable for purposes of the preceding 75% of value test. Section 856(c)(4)(B)(i).

d. Third, not more than 25% of the value of the REIT's assets can be securities of "taxable REIT subsidiaries." Section 856(c)(4)(B)(ii)

(1) For tax years beginning after December 31, 2017, the applicable percentage is 20%.

e. Fourth, except for securities acceptable for purposes of the preceding 75% of value test and securities of taxable REIT subsidiaries, the REIT must not hold securities of any issuer that are:

(1) Greater in value than 5% of the value of the REIT's assets. Section 856(c)(4)(B)(iv)(I).

(2) More than 10% of the voting power of the issuer. Section 856(c)(4)(B)(iv)(II).

(3) More than 10% of the value of the issuer's outstanding securities. Section 856(c)(4)(B)(iv)(III).

(a) Section 856(m) provides a safe harbor for certain investments that will not be treated as "securities" for this 10% of value 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% 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% 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% 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% 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).

f. Fifth, not more than 25% of the REITs assets can be invested in "nonqualified publicly offered REIT debt instruments."

(1) A "qualified" debt instrument of a publicly offered REIT is one that would qualify as a real estate asset without regard to the section 856(c)(5)(B) language that includes "debt instruments issued by publically offered REITs" in real estate assets.

(2) A "nonqualified publicly offered REIT debt instrument" is one that would qualify as a real estate asset only because of the section 856(c)(5)(B) language that includes "debt instruments issued by publically offered REITs" in real estate assets.

g. If a REIT fails to satisfy these asset requirements for a quarter, REIT status will not be automatically lost.

(1) Section 856(c)(4) (flush language) provides that REIT status can be lost when an asset requirement is not met and the failure exists immediately after the acquisition of an asset and results from that acquisition. However, if the

failure is corrected within 30 days of the close of the quarter REIT status will not be lost.

(2) Section 856(c)(7)(A), allows the REIT to cure an asset test failure by filing an informational schedule describing each asset causing the failure, 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. Section 856(c)(7)(C).

(b) Section 856(c)(7)(A) does not apply if (i) the REIT fails to meet the requirements of section 856(c)(4)(B)(iii) (related to "nonqualified publicly offered REIT debt instruments") and (ii) the failure is *de minimus* under section 856(c)(7)(B). A failure is *de minimus* if the failure 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. No tax is due. Section 856(c)(7)(B).

(3) *See* Example #15.

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% of "REIT taxable income," without deducting dividends paid and excluding net capital gain, plus

(2) 90% 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. For the 90% distribution requirement, REIT taxable income excludes both tax-exempt income and net capital gain.

c. "Excess noncash income" is the excess of noncash income over 5% 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).

d. These distribution requirements may be waived if the REIT is unable to comply due to prior distributions made to avoid imposition of the section 4981 excise tax. Section 857(a).

e. 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).

f. *See* Example #16

B. Taxation of REITs

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% 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)

(2) Less the net income from foreclosure property that is taxed by section 857(b)(4),

(3) Less the net income from prohibited transactions that is taxed by section 857(b)(6),

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

(5) Less the tax imposed on income that exceeds the 75% and 95% income tests by section 857(b)(5),

(6) Less the tax imposed on redetermined rents imposed by section 857(b)(7),

(7) Less the tax imposed on asset test failures by section 856(c)(7)(C),

(8) Less the tax on reelection of REIT status imposed by section 856(g)(5).

b. The tax is imposed at section 11 rates.

3. Alternative 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 857(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, i.e., no dividend deduction is allowed for foreclosure income.

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

5. Tax on income from prohibited transactions

a. 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).

b. 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).

6. 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% test.

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

7. Tax on income from redetermined rents, etc.

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

(1) If a taxable REIT subsidiary pays excessive rent or service fees to its parent, the excess income to the REIT is taxed at a 100% to prevent income from being shifted from the taxable subsidiary to the pass-through parent.

(2) "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).

(a) Exceptions to the definition of redetermined rents are available for *de minimus* amounts, comparably priced services, and separately charged services. *See, e.g.*, Rev. Rul. 2002-38.

(3) "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.

(4) "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

a. The REIT is subject to an excise tax on undistributed income. The amount of the excise tax is 4% of the excess of (1) 85% of the REIT's ordinary income plus 95% 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. *See* Example #17

C. <u>Taxation of REIT Shareholders</u>

1. Ordinary income dividends

a. 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).

b. 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

a. 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.

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

3. Undistributed Capital Gains

a. Undistributed capital gain also can be reported as taxable to shareholders, as long-term capital gain. Section 857(b)(3)(D)(i).

b. The REIT pays a tax on undistributed capital gain. Section 857(b)(3)(D)(iv). Shareholders are deemed to have paid that tax. Section 857(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 857(b)(3)(D)(iii).

4. 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.

5. 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).

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Taxation of Real Estate Mortgage Investment Conduits (REMICs)

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% and regular interest holders receive 11%. The residual interest holders may receive the 1% 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 third 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% 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 (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% 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% 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 Investment 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.

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 (i) 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. *See* 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% 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 FASITs, to the extent that regular interests in such FASITs remain outstanding in accordance with the “original terms of issuance.”

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<u>TAXATION OF PROPERTY AND CASUALTY (P&C) INSURANCE COMPANIES</u>

I. <u>General Considerations</u>

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

B. <u>Economic functions</u>

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

a. Receive premiums, create loss reserves, pay claims

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

a. Invest premiums received safe and stable investments

II. <u>Major Tax Concepts</u>

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).

1. TAP seeks to protect the revenue. Income is taxed early (receipt; claim of right), expenses are deferred (all events test; economic performance).

2. GAPP seeks to understate income (going concern value) and protest investors and creditors. Defer income until earned, allow estimated expenses.

3. SAP seeks to protect policyholders (liquidation value). Defer income until earned, allow estimated expenses.

a. SAP increases liabilities to increase assets.

b. While addressing solvency issues, SAP can reduce net income.

D. Additions to reserves are deductions. When amounts are removed from reserves ("reserve releases") those amounts must be included in income.

E. 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."

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. Typically the event that causes a loss to be "incurred" is obvious.

(1) 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:

(1) Reported (or "case") losses:

(a) Incurred, reported, adjusted, and paid

(b) Incurred, reported, adjusted, but not yet paid (even if the claim is resisted)

(c) Incurred, reported, but not yet adjusted

(2) IBNR losses:

(a) Incurred, but not reported

d. 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 ("case reserves").

(1) Reserves for property damage may be based on a repair estimate, appraisal, or some other documentation.

(2) Bodily injury liability reserves are very different and more variable.

(3) The insurer will consider historic data, legal developments, changes in social attitudes and economic conditions, including inflation.

e. IBNR reserves are estimated, based on experience, as a percentage of insurance in force.

f. 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) In *Minnesota Lawyers Mutual Ins. Co. v. Comm'r*, 79 TCM (CCH) 2234 (2000), *aff'd*, 285 F.3d 1086 (8th Cir. 2002), 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%.

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

h. The IRS has 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%. (25% over-reserving.)

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

(6) *See* Example #18.

(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.

i. 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"). *See* LTR 8817001 (July 28, 1987).

j. 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. (due to inflation, more hotly contested claims, larger claims, etc.) 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.

k. 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.

l. Currently, another method used 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.

(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.

F. 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. <u>Income Subject to Tax</u>

A. <u>In General</u>

1. P&C companies are insurance companies that:

a. Qualify as an "insurance company" under section 816(a). Section 831(c). To be an "insurance company" more than half of the company's business must be the business or issuing insurance, annuity contracts, or reinsurance contracts.

b. But, do not qualify as a "life insurance company" under section 816(a). I.e., less than 50% of the company's total reserves are "life insurance reserves" and certain other reserves on noncancellable policies.

2. Questions have arisen regarding what arrangements constitute "insurance."

   a. 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).

   b. 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).

   c. The Supreme Court has held that investment risks are distinct from insurance risks. *Helvering v. Le Gierse*, 312 U.S. 531 (1941); *S.E.C. v. United Benefit Life Ins. Co.,* 387 U.S. 202, 211 (1967).

   d. *Comm'r v. Treganowan*, 183 F.2d 288 (2nd Cir. (1950) (There is no insurance risk unless there is uncertainty or fortuitousness.).

B. <u>Accounting Methods</u>

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).

2. While the NAIC Annual Statement exhibits are "presumed to reflect the true net income of the company," they "will be recognized and used for that purpose" only "insofar as it is not inconsistent with the provisions of the Code. Treas. Reg. § 1.832-4(a)(2).

3. Section 832(b)(6) defines expenses incurred as "all expenses shown on the [NAIC] annual statement.

   a. In *Home Group, Inc. v. Comm'r*, 89-1 U.S.T.C. ¶9329 (2d Cir. 1989), the insurer argued that §832(b)(6) determines when an expense falls into the category of deductible "expenses incurred" (i.e., when it is shown on the NAIC annual statement), while §§832(c) and 162(a) together merely determine whether the expense incurred is deductible (i.e., whether it is "ordinary and necessary").

b. The IRS contended that the insurers position "fails the 'all events' test." The court held that statutory accounting principles are" used as the starting point for tax accounting" and that

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

C. <u>Two Alternatives for Small Companies</u>

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. <u>First</u>, certain P&C insurers may be exempt from tax under section 501(c)(15) if they meet three tests to qualify for tax-exemption:

a. (1) The company must qualify as an "insurance company" as defined in section 816(a);

b. (2) its gross receipts must not exceed $600,000 (for mutual insurance companies the gross receipts limit is reduced to $150,000); and

c. (3) more than 50% of its gross receipts must be premiums (for mutual insurance companies the percent of premiums requirement is reduced to 35%).

3. <u>Second</u>, some P&C insurers may elect to be taxed only on their "taxable investment income." Section 831(b)(2).

a. To be eligible to make the election for years through 2016, the insurer's net written premiums for the taxable year cannot exceed $1,200,000.

(1) To be eligible to make the election for years starting with 2017, the insurer's net written premiums for the taxable year cannot exceed $2,200,000.

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

c. For years starting with 2017 there also are two alternative "diversification requirements" that must be met in order to make the section 831(b) election. Section 831(b)(2)(B).

(1) The first (alternative) requirement is that no more than 20% of net written premiums can be attributable to any one policyholder.

(2) The second (alternative) requirement, which applies if the first requirement is not met, is that no "specified holder" can hold a percentage interest in the insurance company that is more than a "*de minimus* percentage higher than" the percentage interest that specified holder holds in the "specified assets."

(a) This requirement is intended to prevent the use of a P&C insurance company to avoid estate or gift tax

(b) "Specified assets" are the business, rights or assets with respect to which premiums are paid to the insurance company.

(c) A "specified holder" is an individual who (i) holds an interest in the insurance company and (ii) is a spouse or lineal descendant of an individual who holds an interest in the specified assets.

(d) "*De minimus*" is defined as two percentage points or less.

(e) Thus, for example, the requirement is not met if a mother owns the specified assets and her daughters own the insurer.

d. Rules are provided to:

(1) Aggregate the incomes of members of a "controlled group" for purposes of the $1,200,000 (or $2,200,000) net written premiums test. Section 831(b)(2)(C)(i)(I).

(2) Treat members of a "controlled group" as one policyholder for purposes of the diversification requirements. Section 831(b)(2)(C)(i)(II).

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. <u>Premiums earned</u>. "Premiums earned" are "gross premiums written," minus "return premiums," minus "premiums paid for reinsurance," and minus 80% of the increase in the "unearned premiums" reserve (or plus the increase in that reserve).

a. <u>Gross premiums written</u> include "all amounts payable for the effective period of the insurance contract." Treas. Reg. §1.832-4(a)(4)(1). Under Treas. Reg. § 1.832-4(a)(4) and (5) special rules define when specific amounts are included in gross premiums written:

(1) Gross premiums written must be reported for the <u>earlier</u> of (i) the year that includes the effective date of the insurance contract and (ii) the year in which the company receives all or a portion of the gross premium. Treas. Reg. §1.832-4(a)(5)(i).

(a) Thus, gross written premiums can include (i) a full-year premium not received before the effective date and (ii) a full-year premium paid before the contract's effective date.

(b) A contract's "effective date" is the date on which insurance coverage begins. Treas. Reg. 1.832-4(a)(5)(i).

(c) A contract's "effective period" is the period over which rates for insurance coverage are guaranteed. Thus, a five-year contract, with rates that can be adjusted every 12 months, is a series of one year contracts. Treas. Reg. 1.832-4(a)(10), Example 2.

(2) Exception for certain advance premiums.

(a) As noted immediately above, Treas. Reg. § 1.832-4(a)(5)(i) requires that if "all or a portion" of an advance premium is received in the year that precedes the year that contains the effective date, the full gross premium due must be reported as premium written. This is required regardless of annual statement treatment.

(b) An exception to this reporting rule for advance premiums is available. Treas. Reg. § 1.832-4(a)(5)(iii). If this exception applies, only the amount of the advance premium actually received 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.

(c) In order to qualify for this exception, the insurance company's deductions for premium acquisition expenses (*e.g.*, commissions, state premium taxes, etc.) cannot exceed a specified limitation. Treas. Reg. § 1.832-4(a)(5)(vii).

(d) The specified limitation provides that if (i) the percentage obtained by dividing written premiums for the year and previous years by total premiums written equals X% then (ii) the percentage obtained by dividing the sum of deductions premium acquisition expenses for the year and previous years by total premium acquisition expenses cannot exceed X%. Rev. Proc. 2002-46 provides a safe harbor method for determining premium acquisition expenses.

(e) An insurance company that adopts the method of reporting allowed by this exception must apply that method to all contracts with advance premiums.

(3) Premiums payable in installments.

(a) Gross premiums written include all amounts payable for the effective period of the insurance contract, and a company must report gross premiums for the year in which it receives all or a portion of the gross premium. Treas. Reg. §§ 1.832-4(a)(4)1.832-4(a)(5)(i).

(b) Therefore, if premiums on an insurance contract are payable in installments, the full amount of the installments attributable to the effective coverage period (*e.g.*, 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 actually will be received in a later year. Treas. Reg. § 1.832-4(a)(10), Example 1.

(c) 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).

i) Under the exception, an installment premium on a cancellable A&H contract is reportable in the earlier of (i) the tax year in which the installment premium is due, or (ii) the tax year in which the installment premium is received.

ii) In order to qualify for this exception, the insurance company's deductions for premium acquisition expenses related to its cancellable A&H contracts with installment premiums must satisfy the Treas. Reg.

§1.832-4(a)(5)(vii) limitation, discussed above.

iii) An insurance company that adopts the method of reporting allowed by this exception must apply that method to all of its cancellable A&H insurance contracts with installment premiums.

iv) 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).

(4) Exception for certain multi-year insurance contracts

(a) An insurer may treat a non-life insurance contract with an effective period that exceeds 12 months, for which premiums are paid in installments, as a series of separate insurance contracts. The first contract will have an effective period of 12 months, and each subsequent contract will have an effective period of the lesser of 12 months or the remainder of the effective period.

(b) In order to qualify for this exception, the insurance company's deductions for premium acquisition expenses related to its multi-year contracts with installment premiums must satisfy the Treas. Reg. §1.832-4(a)(5)(vii) limitation, discussed above.

(c) An insurance company that adopts the method of reporting allowed by this exception must apply that method to all of its multi-year contracts with installment premiums.

(5) Exception for life insurance contracts, etc.

(a) An insurer may elect to treat premiums on life insurance, annuity, and noncan A&H contracts in accordance with sections 803 and 811(a).

(b) In order to qualify for this exception, the insurance company's deductions for premium acquisition must satisfy the Treas. Reg. §1.832-4(a)(5)(vii) limitation,

(c) An insurance company that adopts the method of reporting allowed by this exception must apply that method to all of its life insurance, annuity, and noncan A&H contracts.

(6) Additional premiums due to increases in risk exposure during the effective period.

(a) Some insurance policies do not have premiums fixed in advance, but premiums that vary with factors subsequently determined (*e.g.*, the number of insured employees). Nevertheless, premiums are billed and paid periodically.

(b) Additional premiums that result from an increase in risk exposure during the effective period of a contract are included in gross premiums written for the year in which the change in risk exposure occurs. The additional premiums are based on the change in risk exposure for the remainder of the effective period. Treas. Reg. §§ 1.832-4(a)(4)(ii)(A) and (a)(5)(ii). *See, e.g.*, Treas. Reg. §1.832-4(a)(10), Example 6.

(c) 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.

(7) Premiums written also include mounts subtracted from a premium stabilization reserve to pay for insurance coverage. Treas. Reg. § 1.832-4(a)(4)(ii)(B).

(8) Finally, premiums written include 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).

b. Gross premiums written are reduced by <u>return premiums</u> and <u>reinsurance premiums</u>. 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:

(a) Amounts paid as premiums that are refundable by the insurance company due to policy cancellations or reduced risk exposure,

(b) Amounts reflecting the unearned portion of unpaid premiums that are refundable due to policy cancellations or reduced risk exposure, and

(c) 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).

(5) Reinsurance premiums are premiums paid for reinsurance.

c. Gross premiums written are reduced by <u>unearned premiums</u>

(1) "Unearned premiums" are "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) With respect to retrospectively rated contracts, "retro credits" cannot be added to unearned premiums and "retro debits" cannot be subtracted from unearned premiums. Treas. Reg. § 1. 832-4(a)(8)(1).

(a) The IRS has not provided guidance on the proper treatment of experience rated refunds. The most logical answer is to treat them as return premiums.

(3) Generally, unearned premiums are determined pro rata over the policy period. However, if the risk of loss is not uniform over the policy period, a non-pro rata method can be used. Treas. Reg. §1.832-4(a)(9).

(4) Increases in unearned premium reserves are deductions, while decreases in unearned premium reserves are income. Section 832(b)(4)(B).

(5) In determining increases and decreases in the unearned premium reserve, only 80% of the year-end balances of the unearned premium reserve are used. Section 832(b)(4)(B).

(a) Thus, if the year-end 2015 reserve balance is $100 and the year-end 2016 reserve balance is $200, the increase in the reserves for tax purposes is not $100, but $80 ($160 minus $80).

(b) Note the interaction with the premiums written rules:

i) Assume a calendar-year, one-year contract with $100 quarterly installment premiums. Before the January 1 effective date, the policyholder pays the first $100 premium. In the prior to the effective date, the insurer has $400 of written premiums. In that year, the insurer has $160 of premiums earned, equal to $400 minus the increase in unearned premiums of $240 (80% of $300).

ii) If the advance premium exception applied, in the year before the effective date the insurer has $20 of premiums earned, equal to $100 of premiums written minus the increase in unearned premiums of $80 (80% of $100).

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

(a) 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.

(7) A P&C company's life insurance and annuity reserves and reserves for noncan and guaranteed renewable A&H contracts are calculated under 807. Unearned premiums on these contracts are not subject to the 20% reduction provision.

(8) Example #20 illustrates the computation of "premiums earned."

2. Losses incurred

a. Losses incurred equal: Section 832(b)(5)

(1) Losses paid,

(a) Reduced by salvage and reinsurance recovered.

(2) The increase in discounted unpaid losses

(a) Reduced by the increase in estimated salvage and reinsurance recoverable.

(3) Reduced by 15% of tax-exempt interest and the sections 243 and 245 dividends received deductions (DRD)

b. <u>Losses paid</u> and <u>salvage and reinsurance recovered</u> are actual amounts paid and received.

c. <u>Discounted unpaid losses</u> are computed via several steps:

(1) <u>First</u>, "undiscounted unpaid loss" reserves from the NAIC annual statement are identified.

(a) If the unpaid loss reserve on the annual statement is already discounted, that discounting can be reversed.

(2) <u>Second</u>, the "unpaid loss adjustment expenses" (LAE) are excluded from expenses incurred and included in unpaid loss reserves. Sections 832(b)(6) and 846(f)(2).

(3) <u>Third</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.

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

(b) 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).)

(c) The present value of the unpaid losses is determined using (see section 846(a)(2)):

  i) The undiscounted unpaid losses reserves,

  ii) An assumed interest rate, and

  iii) An assumed loss payment pattern.

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

(d) 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).

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

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

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

(f) 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).

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

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

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

(g) 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).

(h) 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).

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

(4) <u>Fourth</u>, the losses incurred deduction is reduced by the increase in estimated salvage and reinsurance recoverable. 832(b)(5)(A).

(a) Estimated salvage and reinsurance recoverable includes all anticipated recoveries based on the facts and the company's experience with similar cases. Treas. Reg. § 1.832-4(c).

(b) Treasury Regulation § 1.832-4(c) sets forth the manner in which the discounting calculations are to be performed. Discounting can be performed either:

i) Using the applicable discount factors published by the IRS, or

ii) Using a loss payment pattern and applicable interest rate per section 846.

d. Fifth, the total "losses incurred" deduction is reduced by an amount equal to 15% of specified amounts. 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) The 15% is applied to:

(a) Tax-exempt interest,

(b) Non-100% dividends received,

(c) The portion of 100% dividends attributable to tax-exempt interest and non-100% dividends (called "prorated amounts,"), and

(d) The increase in policy cash values of policies to which section 264(f) applies.[2]

(3) Explanation of section 832(b)(5)(B)(i)(II):

(a) Prior to 1997, the tax-favored income subject to proration included tax-exempt interest and dividends subject to the DRD.

(b) After 1996, the inside build-up under life insurance contracts held by insurance companies on their employees (I-COLI) also is viewed as tax-favored income.

(c) Thus, the inside build-up on I-COLI is now subject to proration.

(d) Rev. Proc. 2007-61 provides as a safe harbor that an insurance company is not required to take into account the increase in policy cash values on I-COLI contracts covering no more than 35% of the

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[2] Section 264(f) does not apply to insurance companies. But, if an insurance company holds policies of a type generally taken into account in determining borrowed policy cash value under 264(f) then those policies enter into proration calculations. *See* Rev. Proc. 2007-61, 2007 C.B. 747.

total aggregate number of the individuals described in § 264(f)(4)(A).

(4) If the insurer receives a 100% dividend from a subsidiary that is an insurance company, and if a portion of that 100% dividend is attributable to "prorated amounts," the proration adjustment at the parent level will be reduced (but not below zero) by any proration adjustment made at the subsidiary level. Section 832(b)(5)(E).

(a) Assume the P&C subsidiary received $100x of tax-exempt interest and reduced its losses incurred deduction by $15x. If that $100x of tax-exempt interest was distributed to the parent, no proration adjustment due to the $100 distribution would result at the parent level.

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

(6) 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).

(7) 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. Example #21 illustrates the computation of "losses incurred."

f. 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).

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

F. The IRS has addressed the treatment of indemnity reinsurance. PLR 201506008 (indemnity insurance qualifies as part of a section 351 transaction); PLR 201511015.

V. <u>Blue Cross and Blue Shield Organizations</u>

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 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 entitled 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" are reserves for unaccrued, non-incurred losses that 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. Qualification as a "Life Insurance Company"

1. To qualify as a "life insurance company," a company must be an "insurance company."

a. 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).

b. A corporation was not a life insurance company because it did not aggressively engage in the life insurance business and its investment income far exceeded its earned premiums. Inter-*American Life Insurance Co*, 56 T.C. (1971), *aff'd*, 469 F.2d 697 (9th Cir. 1971).

c. 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. For an insurance company to be taxed as a "life insurance company":

   a. The insurance company must be engaged in the business of issuing certain types of insurance contracts (section 816(a)):

      (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. *See* Section 72.

      (3) Noncancellable A&H contracts (noncan A&H). A&H contracts pay benefits for sickness or accidental injury or death.

         i) To be considered noncancellable, the issuing company must be obligated to renew the contract at a specified premium through the insured's 60^{th} birthday. Treas. Reg. 1.801-3(c).

         ii) In addition, the company must hold both an unearned premium reserve and an "additional reserve" for the policy. If no reserve is maintained in addition to unearned premiums a policy is not a noncancellable A&H policy. Rev. Rul. 75-542, 1975-2 C.B. 261.

      (4) Guaranteed renewable A&H contracts. These contracts are treated as noncan A&H. Section 816(e).

         (a) 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. Treas. Reg. 1.801-3(d).

         (b) In addition, the company must hold both an unearned premium reserve and an "additional reserve" for the policy.

3. Finally, more than 50% 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).

a. "Life insurance reserves" are defined in the Code as amounts that are: (section 816(b)):

(1) Computed or estimated on the basis of recognized tables and assumed rates of interest,

(2) Set aside to liquidate future unaccrued claims arising from life insurance, annuity, and noncan and guaranteed renewable A&H contracts which involve life or A&H contingencies,

(3) Required by law.

b. "Total reserves" are defined as: (section 815(c))

(1) Life insurance reserves,

(2) Unearned premiums and unpaid losses not included in life insurance reserves,

(a) The term "unpaid losses" in § 816(c)(2) includes only unaccrued unpaid losses, and does not include accrued unpaid losses. *Best Life Assurance Co. of California v. Comm'r*, 281 F3d 828 (9th Cir. 2000).

(3) All other reserves required by law.

c. Only for purposes of whether an insurance company is a life insurance company, both life insurance reserves and total reserves will be reduced by policy loans on contracts for which life insurance reserves are held. Section 816(d).

C. <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 (future, unaccrued) liability to pay those benefits.

2. Life insurance policies that have life insurance reserves 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. Thus, premiums on term life insurance policies generally increase with age.

4. 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.

5. Under the mean reserve method, the mean life insurance reserve as of the December 31, 2016 valuation date is as follows:

$$\frac{\text{Reserve at 6-30-2016} + \text{Reserve at 6-30-2016}}{2} + \frac{\text{Annual Premium}}{2}$$

6. Viewed retrospectively, the total reserve for life insurance policies equals the total of premiums paid, plus interest thereon, less benefits already paid.

7. Viewed prospectively, the total reserve for life policies equals the present value of future benefits less the present value of future premiums. *See* Example #22.

8. All states follow the prospective view, which is embodied in the Standard Valuation Law.

D. <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.

E. <u>Valuation Methods</u>

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.

F. <u>Mortality Tables</u>

Mortality tables are used to predict mortality, and are used in reserve and premium calculations.

G. <u>Assumed Rates of Interest</u>

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.

H. Other elements, too complex to be discussed here, also enter into the reserve computations.

III. <u>Current Taxation of Life Insurance Companies</u>

A. Tax is Imposed on Life Insurance Company Taxable Income ("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).

B. <u>Life Insurance Gross Income</u>

1. Gross premiums are included in income. Section 803(a)(1)

a. Premiums include advance premiums, deposits, fees, assessments consideration received for reinsurance, and dividends reimbursed by a reinsurer. Section 803(b)(1).

b. Gross premiums are reduced by return premiums and indemnity reinsurance premiums paid. Section 803(a)(2).

2. Decreases in reserves are included in income. Section 803(a)(2) and 807(a).

a. As described later, the amount of any decrease in reserves is increased by the policyholders' share of tax-exempt interest. Sections 807(a)(2)(B) and 812.

3. Gross income includes all other amounts, including the total amount of investment income (but not tax-exempt interest). Section 803(a)(3).

C. Life Insurance Deductions

1. Section 804 provides that life insurance deductions include:

a. The "small life insurance company deduction," provided by section 806(a), and the

b. "General deductions," specified in section 805.

2. The small life insurance company deduction

a. The deduction is allowed only to companies that have assets at the close of the tax year that total less than $500 million. Section 806(a)(3).

(1) For the $500 million determination, the fair market value of stock and real property is used. For other assets, the basis used to determine gain or loss on a sale is used. Section 806(a)(3)(C).

(2) Life insurance companies in a controlled group are aggregated. Sections 806(c) and 1563 (80% of vote and value test).

b. The deduction is equal to 60% of so much of "tentative LICTI" that does not exceed $3,000,000. Section 806(a).

(1) Thus, the maximum deduction is $1,800,000.

c. "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. Section 806(b).

(1) Insurance business includes performing administrative services for life insurance, A&H or pension plans, as well as any investment activity that does not constitute the active conduct of a trade or business. Section 806(b)(3).

d. If tentative LICTI exceeds $3,000,000, the deduction phases out by 15% of the tentative LICTI that exceeds $3,000,000.

(1) Thus, for example, for a company with tentative LICTI of $4,000,000, the deduction is reduced by $150,000.

(2) For companies with tentative LICTI equal to or over $15,000,000 the deduction is zero.

3. The general deductions are specified in section 805. These deductions are somewhat similar to the deductions in former section 809(d).

a. Claims and benefits accrued, and losses incurred, are deductible. Section 805(a)(1).

b. The increase in reserves is deductible. Section 805(a)(2) and 807(b).

(1) As described below, the amount of any increase in reserves deductible from income is reduced by the policyholders' share of tax-exempt interest. Sections 807(b)(1)(B) and 812.

c. Policyholder dividends are deductible. Section 805(a)(3) and 808.

(1) See discussion of policyholder dividends, infra.

d. The dividends received deduction (DRD) is allowed. Section 805(a)(4).

(1) As described below, only the company's share of the DRD may be allowable. Sections 805(a)(4) and 812.

e. In addition, operations losses, assumption reinsurance premiums, payments of reimbursable dividends, and all other deductions allowed under the Code, subject to some modifications, are allowable to life insurance companies. Section 805(a) and (b).

D. Reserves for Life Insurance Companies

1. Reserve increases (or decreases) allocable to both premiums and investment income constitute an expense (or income). Sections 807(a) and (b).

a. As discussed below, under proration provisions, closing reserve balances are reduced by the policyholders' share of:

(1) Tax-exempt interest, and

(2) The increase in policy cash values for policies to which section 264(f) applies.

2. The reserve "items taken into account" for these purposes include not only "life insurance reserves," but also unearned premiums, unpaid losses, etc. Section 807(c).

3. Life Insurance Reserves

   a. For purposes of qualification as a life insurance company under section 816, annual statement life insurance reserve amounts utilized. For purposes of computing life insurance company taxable income, however, annual statement life insurance reserves must be recomputed. Section 807(d)(1).

   b. The general rule for life insurance reserves:

      (1) 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).

      (2) 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) For purposes section 807(d)(1) and 807(d)(6), deficiency reserves are included in statutory reserves. IRS Notice 2013-19.

         (b) The amount of a company's statutory reserves under § 807(d)(6) is the highest aggregate reserve amount for § 807(c) items actually held and set forth on the annual statement pursuant to the minimum reserve requirements of any state in which the company does business. Rev. Rul. 2008-37, 2008-2 CB 77.

   c. Net surrender value is determined:

      (1) With regard to any penalty or charge imposed on surrender, but

      (2) Without regard to any market value adjustment. Section 807(e)(1).

   d. Federally prescribed reserves are computed using: (section 807(d)(2))

      (1) A specified tax reserve method. Section 807(d)(2)(A).

         (a) Various preliminary term methods are specified.

(b) For life insurance, CRVM must be used. Section 807(d)(3)(B)(i).

(c) For annuities, CARVM must be used. Section 807(d)(3)(B)(ii).

(d) For noncan A&H contracts, a 2-year full preliminary term method must be used. Section 807(d)(3)(B)(iii).

(e) Section 807(d)(3)(B) requires that taxpayers use CRVM or CARVM as prescribed by the NAIC as of the date the contact was issued. If the NAIC is silent on the CARVM issue, taxpayers must use the prevailing state practice. LTR 200448046 (Aug. 30, 2004).

(f) Issuance of AG 33 did not amend the SVL, nor did it change the definition of the CARVM. Instead, AG 33 interpreted the proper application of the CARVM. *American Financial Group v. U.S.*, 678 F3d 422 (6th Cir. 2012).

(2) The greater of a prevailing State assumed interest rate and an AFR rate. Section 807(d)(2)(B)

(a) The AFR is the section 842(c)(2) annual rate determined by the IRS for the year in which the contract is issued. Section 807(d)(4)(A).

i) A company may elect to re-compute the reserves for a contract every five years using a then-current AFR. Once the election is made, the company must continue it.

(b) The prevailing state assumed interest rate is the highest assumed interest rate allowed to be used for the contract under the insurance laws of at least 26 states at the beginning of the calendar year in which the contract is issued. Section 807(d)(4)(B).

(c) The IRS annually provides AFRs and prevailing state assumed interest rates for determination of reserves. *See, e.g.*, Rev. Rul. 2016-2.

(3) Prevailing state mortality or morbidity tables. Section 807(d)(2)(C).

(a) The prevailing commissioners' standard tables are the most recent tables allowed to be used for the contract under the insurance laws of at least 26 states at the date the contract is issued. Section 807(d)(5)(A).

(b) If the prevailing commissioners' standard tables as of the beginning of a calendar year differ from such tables as of the beginning of the preceding year, the company may use the old tables for any contract issued after the change but before the end of a 3-year period beginning on the first day of the year of change.

(c) Treas. Reg. § 1.807-1 contains mortality and morbidity tables to be used if there are no commissioners standard tables applicable to an insurance contract when the contract is issued.

(d) See also Rev. Rul. 92-19, 1992-1 C. B. 227, which has been supplemented by multiple revenue rulings, including Rev. Rul. 2014-4.

e. Special rules apply for computing reserves for supplemental benefits. Section 807(e)(3).

(1) "Supplemental benefits" are guaranteed insurability benefits, accidental death or disability benefits, convertibility benefits, and disability waiver benefits.

(2) For these reserves, annual statement statutory reserves are allowable for tax purposes.

(3) A supplemental benefit may be a "qualified supplemental benefit." Section 807((e)(3)(C).

(a) To be a "qualified supplemental benefit":

i) There must be a separately identified premium or charge for the benefit. LTR 9442001 (June 7, 1994).

ii) Any net surrender value under the contract attributable to any other benefit cannot be available to fund the supplemental benefit. Section 807(e)(3)(C).

(4) If the reserve is not for a "qualified" supplemental benefit, the reserve is treated as part of the reserve for the contract as a whole. Section 807(e)(3)(B).

(a) Assume the contract has a federally prescribed reserve of $3800 and a NSV of $4000, and that the benefit has a statutory reserve of $50. The allowable reserve is the $4000 NSV, as that amount exceeds $3850, the sum of the federally prescribed reserve of $3800 plus the statutory reserve of $50.

(5) If the reserve is for a "qualified" supplemental benefit, the reserve is computed as if the benefit were provided under a separate contract. Section 808(c)(3)(A)(i); LTR 9620001 (Jan. 23, 1996).

(a) Assume the contract has a federally prescribed reserve of $3800 and a NSV of $4000, and that the benefit has a statutory reserve of $50. The allowable reserve for the separately treated contract is the $4000 NSV, as that amount exceeds the federally prescribed reserve of $4000. The reserve for the separately treated qualified supplemental benefit is $50.

(b) To be "qualified," the policy must show a separately identified premium or charge for the benefit. It is irrelevant that a separately identified premium or charge could exist in rate manuals, premium worksheets, or other company documents. LTR 9442001 (June 7, 1994).

f. Reserves for "qualified substandard risks" also are computed separately from other contract reserves. Section 807(e)(5).

(1) To be qualified, the company must maintain a separate reserve for the risk, there must be a separately stated premium or charge for the risk, the NSV must be unaffected by the risk, and the NSV must not regularly be used to pay premium charges for the risk.

4. 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).

5. Under pension deposit contracts, the reserves equal the policyholder's fund as defined in section 807(e)(1)(B). LTR 9452001 (Aug. 26, 1994).

6. The IRS has described how the amount of the life insurance reserves taken into account under section 807 for a variable contract are computed where some or all of the reserves are accounted for as part of a life insurance company's separate account reserves. Rev. Rul. 2014-7.

7. If a company changes its method of computing reserves, the change may qualify as a "change in basis." Section 807(f).

   a. The IRS' consent is not required and the resulting change in reserves is taken into account ratably over 10 years.

   b. 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.

   c. Rev. Rul. 2002-6, 2002-6 I.R.B. 460, concludes that a change in reserve computations to conform to NAIC guidelines was a change in basis for purposes of section 807(f).

   d. The IRS considers section 807(f) to be a subset of accounting method changes governed by section 446. PLR 201511013.

8. 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 "principles-based reserves" (PBRs). *See* Notice 2008-18.

   a. PBR reserves are based on company-specific modeling.

   b. These stochastic reserves do not comply with Section 807.

E. <u>Policyholder Dividends</u>

1. The definition of policyholder dividends

   a. Policyholder dividends include amounts not fixed in the contract but that depend on the experience or discretion of the insurer, excess interest, premium adjustments, and experience rated refunds. Section 808(b).

2. Policyholder dividends are deductible only to the extent "paid or accrued." Section 808(c).

a. Dividends generally are payable on the anniversary date of a policy. Most companies pay policyholder dividends only if all premiums due have been paid and the policy actually is in force on the anniversary date. Because payment of these policyholder dividends is contingent, they do not meet the all events test and are not accrued.

b. Some companies pay "pro rata" dividends. These dividends become irrevocably payable, on a pro rata basis, over time. Thus, if a policy has an October 1st anniversary date, as of December 31st 25% of the annual dividend is accrued.

c. In *New York Life Insurance Co. v. U.S.*, 2011-1 U.S.T.C. ¶ 50373 (S.D.N.Y. 2011.), *aff'd*, 724 F.3d 256 (2nd Cir. 2013), the court held that the taxpayer may not accrue and deduct in the taxable year either:

(1) Annual dividends on policies for which all premiums have been paid and that are credited to the policyholder's account in the taxable year (and as a result are payable in all events) but that, under the terms of the policy, are not payable until the anniversary date in the first month of the succeeding taxable year, or

(2) 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.

d. In *MassMutual v. U.S.*, 103 Fed. Cl. 111 (2012), aff'd, 782 F.3d 1354 Fed. Cir 2015), the court held that dividends subject to an aggregate guarantee could be accrued and deducted.

(1) The court held that the aggregate guarantee creates a liability that meets the all events test.

(2) The court also held that the liability *i.e.* eligible for the recurring items exception to the economic performance requirement as a "rebate or refund."

3. An insurer may not pay a policyholder dividend in cash, but rather increase cash surrender value, increase other policy benefits, or decrease premiums otherwise due.

a. In such a case, the dividend is treated as paid to the policyholder and then returned to the insurer as a premium. Section 808(e).

4. When a mutual company demutualizes, it may distribute cash and stock to policyholders. It has been held that such distributions are not policyholder dividends. *UNUM Life Ins. Co. v. U.S.*, 929 F. Supp. 15 (D. Me. 1996), aff'd, 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.

5. In the 1984 Act, companies were taken off the prior reserve method for deducting policyholder dividends and placed on the paid or accrued method. Normally, this change from the reserve method to the accrual method would have been a change in method of accounting, and the year-end 1983 dividend reserve would have been brought into income as a section 481 adjustment. However, the 1984 Act gave the dividend reserves a "fresh start" and no section 481 adjustment was required to be made.

   a. If a company changes its policyholder dividend "business practices" in order to "accelerate" its dividend deductions then the policyholder dividends deduction for the year is reduced by the amount of the acceleration, but not by an amount that exceeds the fresh start. Section 808(f).

   b. For example, dividend acceleration will occur if a company without a pro-rata dividend practice adopts such a practice, or if a company without an aggregate guarantee adopts such a guarantee.

   c. This dividend acceleration rule does not apply to policies issued after December 31, 1983 (which received no "fresh start").

      (1) The *Massachusetts Mutual* case involved a change in business practices, but only for post-1983 policies.

      (2) The *New York Life* case did not involve a change in business practices.

F. <u>Proration – In General</u>

1. Unlike the case for P&C companies, there is no one, specified proration percentage. Rather, each life insurance company must compute its own "company's share" and "policyholders' share" percentages. Section 812.

2. The statute prorates the DRD and tax-exempt interest differently:

   a. Generally, a company may deduct only the "company's share" of the dividends received deduction. Section 805(a)(4).

b. The "policyholders' share" of tax-exempt interest then reduces the deduction for reserve increases (or increases the income from reserve decreases). Sections 807(a) and (b).

3. Determining the company's share and policyholders' share

a. The "company's share" is:

(1) The company's share of net investment income, divided by

(2) Net investment income. Section 812(a)(1).

b. The "policyholders' share" is 100% minus the company's share. Section 812(a)(2).

c. The "company's share of net investment income" is:

(1) Net investment income,

(2) Minus policy interest,

(3) Minus the gross investment income's proportionate share of policyholder dividends.

d. Net investment income is 90% of "gross investment income." For separate accounts, the percentage is 95%. Section 812(c).

(1) Gross investment income is broadly defined in section 812(d).

(2) Gross investment income does not include 100% dividends. However, 100% dividends do not include distributions out of tax-exempt interest and dividends that are not 100% dividends. Section 812(e).

e. "Policy interest" includes:

(1) Required interest on reserves,

(2) The deductible portion of excess interest,

(3) The deductible portion of amounts credited to a pension plan contract policyholder's fund or to a deferred annuity before the annuity starting date.

(4) Interest on amounts left on deposit with the company. Section 812(b)(2).

f. The "gross investment income's proportionate share of policyholder dividends" is:

(1) The deductible portion of the policyholder dividends (with specified exclusions), multiplied by

(2) A so-called "mini-fraction. Section 812(b)(3).

(a) The numerator of the fraction is gross investment income (including tax-exempt interest) minus policy interest.

(b) The denominator of the fraction is life insurance gross income less any increase in reserve items.

4. CCA 201603023 (computation of gross investment income under section 812 for separate accounts invested in partnership funds)

5. *See* Example #25

G. Proration – Sections 805(a)(4)(D)(iii), 807(a)(2)(B), and 807(b)(1)(B):

1. Prior to 1997, the tax-favored income subject to proration included tax-exempt interest and dividends subject to the DRD.

2. After 1996, the inside build-up under life insurance contracts held by insurance companies on their employees (I-COLI) also is viewed as tax-favored income.

3. Thus, the inside build-up on I-COLI is now subject to proration.

4. Rev. Proc. 2007-61 provides as a safe harbor that an insurance company is not required to take into account the increase in policy cash values on I-COLI contracts covering no more than 35% of the total aggregate number of the individuals described in § 264(f)(4)(A).

H. Proration of the Dividends Received Deduction (DRD)

1. A deduction is allowed for dividends received from other corporations. Section 805(a)(4).

2. If the insurer receives a dividend that is not a "100% dividend," only the "company's share" of the dividend it taken into account in computing the dividends received deduction (DRD). Sections 805(a)(4)(A)(ii) and 812.

3. "100% dividends" generally are not subject to proration and are fully deductible. Sections 805(a)(4)(A)(i).

a. 100% dividends are dividends that receive a 100% DRD. Sections 805(a)(4)(C)(i).

4. However, 100% dividends are subject to proration in certain instances. There rules apply to prevent a life insurance company from avoiding proration by having a subsidiary receive tax exempt interest or dividends that are not 100% dividends.

   a. The 1984 Act Bluebook states that "multi-tiered corporate ownership arrangements cannot be used to change the character of the tax-exempt interest and dividends received in an attempt to avoid proper proration.

   b. 100% Dividends from life insurance subsidiaries

      (1) A parent life insurance company's 100% DRD deduction may be reduced if distribution from the life subsidiary contains "prorated amounts," which are:

         (a) Tax-exempt interest,

         (b) Dividends received that are not 100% dividends, and

         (c) Increase in policy cash values of policies to which section 264(f) applies. Section 805(a)(4)(D)(iii).

      (2) The reduction will occur if the paying subsidiary's "company's share" exceeds the life parent's "company share." Section 805(a)(4)(D)(i).

      (3) The amount of the reduction is the amount of the 100% dividend that is attributable to prorated amounts times the excess of the subsidiary's "company's share" over the life parent's "company share." Section 805(a)(4)(D)(ii).

   c. 100% Dividends from non-life insurance subsidiaries

      (1) "Rules similar to" those in section 805(a)(4)(D) shall apply. Section 805(a)(4)(E).

   d. 100% Dividends from noninsurance company subsidiaries

      (1) Some amounts are removed from a 100% dividend and treated like a non-100% dividend, thus becoming subject to proration. Section 805(a)(4)(C)(ii).

(2) The amounts removed from a non-100% dividend are the amounts contained in the distribution that are out of the distributing company's:

(a) Tax-exempt interest,

(b) Dividends received that are not 100% dividends, and

(c) Increase in policy cash values of policies to which section 264(f) applies.

(3) Assume the subsidiary has current E&P of $100x, $40x of which is attributable to tax-exempt interest. If the subsidiary makes a dividend distribution of $100x, the 100% dividend will be $60x and the non-100% dividend subject to proration will be $40x.

I. Proration of Tax-Exempt Interest

a. To effect proration for tax-exempt interest, closing reserve balances are reduced by the policyholders' share of:

(1) Tax-exempt interest, and

(2) The increase in policy cash values for policies to which section 264(f) applies. Sections 807(a) and (b), and Section 812.

J. Deferred Acquisition Costs (DAC)

1. Section 848 provides for the capitalization and amortization of "specified policy acquisition expenses."

2. Section 848 does not measure actual acquisition costs incurred in acquiring policies. 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 noncancellable 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. *See* Example #26.

11. Ceding commissions in excess of amortized DAC are required to be capitalized and amortized under section 197. CCA 201501011.

K. <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 <u>unrelated</u> 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.

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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. *See* 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).

e. Insurers seeking relief from a failure to qualify as life insurance must submit a ruling request that meets requirements of Rev. Proc. 2008-1 and the identify contract policy number, reasons for disqualification, and what administrative procedures the insurer implemented to prevent further failures. In cases involving Code section 7702(c) failures, the insurer must submit a duly executed proposed closing agreement, in triplicate, in same form as model agreement provided by this procedure. Rev. Proc. 2008-40, 2008-2 C.B. 151.

8. Section 7702 applies to contracts issued after 1984. Contracts issued in <u>exchange for existing contracts after 1984 may be subject to the new</u> 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. *Smith v. Comm'r*, TC Memo 1995-402 (1995).

2. But, 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.

a. An employee will have to report an employer's premium payments as compensation income. Section 62.

3. Premiums paid by any taxpayer on any life insurance, annuity or endowment policy (regardless of whom it covers) are not deductible if the taxpayer is directly or indirectly a beneficiary under the contract. Section 264(a)(1).

a. *National Ind. Invs. V. Comm'r*, T.C. Memo 1996-151 (section 264(a)(1) applies to taxpayer that is a 40% beneficiary of a policy).

b. Section 72(s)(5) and 72(u) annuity contracts are excepted.

4. Under section 264(a)(1), if an 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. This often is called "key person" life insurance.

   a. Thus, premiums are not deductible on life insurance which names an employer corporation as the beneficiary and which is used:

      (1) 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.

      (2) to secure a loan to the employer.

5. 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). *See* Example #27.

   a. The term "employee" includes former employees. Section 79(e).

   b. No amount is included in the employee's income if the employer or a charity is the beneficiary. Section 79(b)(2).

   c. Moreover, no amount is included in the income of a terminated employee who is disabled. Thus, no amounts are included in the individual's income even if the coverage exceeds $50,000. Section 79(b)(1).

   d. If the group-term insurance plan discriminates in favor of key employees, such key employees do not get the income exclusion. Section 79(d). A plan is nondiscriminatory if:

      (1) The plan benefits 70% or more of the employer's employees,

      (2) At least 85% of covered employees are not key employees, and

      (3) The IRS determines that the plan is not discriminatory in favor of key employees.

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 secured by 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.

a. Most interest on policy loans on life insurance policies of individuals will be nondeductible under the "personal interest" rules of section 163(h).

b. If the loan is taken for investment purposes, the investment interest rules apply. Section 163(d).

2. No interest is deductible on indebtedness incurred to purchase or carry single-premium policies. Section 264(a)(2).

a. Such policies include policies on which substantially all of the premiums are paid within 4 years of the date of purchase. Section 264(c)(1).

b. Such policies also include policies for which an amount is deposited with the insurer for the purpose of paying a substantial number of future premiums. Section 264(c)(2)

3. 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. This rule does not apply to single premium contracts.

b. A safe harbor is provided if:

(1) 4 out of the first 7 annual premiums are not borrowed. Section 264(d)(1). *But see*, 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),

(2) The total (not per policy) annual interest does not exceed $100,

(3) The debt was incurred due to an unforeseen substantial loss of income or increase in financial obligations, or

(4) The debt is incurred in connection with a trade or business (and not to purchase life insurance).

4. In general, no interest is deductible on indebtedness with respect to life insurance, annuity or endowment policies owned by the taxpayer covering any individual. Section 264(a)(4).

a. This provision greatly limits the use of corporate owned life insurance (COLI).

b. Under an exception, however, interest deductions are allowed on debt incurred with respect to insurance policies on a limited number of "key persons." Section 264(e).

c. Key employees are either officers or 20% owners of the employer.

d. The number of key employees cannot exceed the greater of

(1) 5 individuals, or

(2) The lesser of 5% of the total number of officers and employees or 20 individuals.

e. Thus, a taxpayer cannot have more than 20 key employees.

f. Interest is deductible only on up to $50,000 of borrowing per employee. Section 261(e)(1).

g. However, the amount of interest deductible cannot exceed that credited at a specified "applicable rate of interest," which is a Moody's Corporate Bond Yield Average. Section 264(e)(2).

5. Section 264 order of application rules:

a. If policy is not a single premium policy under section 264(a)(2), such policy then needs to satisfy section 264(a)(4).

b. If a multi-premium policy does not violate section 264(a)(3), such policy then needs to satisfy section 264(a)(4).

6. 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 that is "allocable to unborrowed policy cash values." Section 264(f).

a. A taxpayer may have a policy whose cash value exceeds the policy loan, i.e., unborrowed policy cash value. If so, a portion of the taxpayer's total interest expense will be allocated to the unborrowed CSV and that amount will be disallowed as a deduction.

b. The theory is akin to that underlying the pro rata interest disallowance rule of section 265(b), i.e., that all a taxpayer's borrowings relate to the purchase or carrying of all the taxpayer's assets.

c. 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.

d. The amount of interest expense "allocable to" the unborrowed policy cash values, for which a deduction is disallowed, is calculated as follows:

(1) The aggregate amount of allowable interest expense without regard to sections 264(f), 265(b) and 291 (see section 264(f)(7)) multiplied by:

(2) The taxpayer's average unborrowed policy cash values for contracts issued after June 8, 1997, over 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).

e. Exceptions to the pro rata interest disallowance rule are provided. Section 264(f)(4) and (f)(5).

(1) Importantly, one exception covers certain policies owned by an employer engaged in a trade or business, and that cover a single individual, if that individual is a 20% owner, officer, director, or employee.

(2) Another exception covers policies held by natural persons, unless a trade or business is directly or indirectly the beneficiary of the policy. Section 264(f)(5).

f. Section 264(f) does not apply to insurance companies. Section 264(f)(8).

(1) Insurance companies, however, as discussed above, are subject to analogous provisions that modify losses incurred, reserve increase deduction rules, and proration rules.

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. Withdrawals of Cash Value

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, or surrenders the 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. Policyholder dividends are subject to the investment-first ordering rule. Section 72(e).

4. Example: Policyholder had paid premiums of $64,000 on a life insurance policy, then surrendered the policy and received the $78,000 cash value. The policyholder had ordinary income of $14,000, the excess of the $78,000 received over the $64,000 investment in the contract. Rev. Rul. 2009-13, Situation 1.

5. 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).

6. 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.

        (1) 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. Section 72(e)(2)(B).

    c. Moreover, loans are treated as distributions. Section 72(e)(10).

d. Such distributions also are subject to a 10% additional tax, subject to certain exceptions (e.g., distributions after age 59-1/2 or taken due to disability). Section 72(v).

e. 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.

7. <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.

a. To be a life insurance contract, section 7702 must be met.

2. <u>Transfer for Value Rule</u>: However, if the recipient of the death benefits has purchased the policy for value, then the death benefits generally are taxable to the extent that they exceed:

a. The amount paid for the policy, plus

b. Any premiums or other amounts subsequently paid. Section 101(a)(2).

c. <u>Example:</u> Buyer purchased a life insurance policy for $20,000. After paying $9,000 of premiums, the insured died and the buyer was paid $100,000 in death proceeds. The buyer has ordinary income of $71,000, equal to the $100,000 received less $29,000 ($20,000 plus $9,000). Notice 2009-14, Situation 1.

d. There are two exceptions to this transfer-for-value rule (section 101(a)(2)(A)&(B)):

(1) If the transferee's basis is determined by reference to the transferor's basis (*e.g.*, the policy was a gift or was received in an acquisitive reorganization).

(2) If the transfer is to the insured, a partner of the insured, or the insured's partnership or corporation (*e.g.*, buy-sell contracts).

3. The seller of the policy may recognize gain or loss on the sale.

a. Because the seller paid for and received annual insurance protection while it held the policy, its basis in the policy must be reduced by the cost of insurance charges subtracted from cash value. *Century Wood Preserving Co. v. Comm'r*, 69 F.2d 967 (3rd Cir. 1934); *London Shoe Co. v. Comm'r*, 80 F.2d 230 (2d Cir. 1935); *Keystone Consolidated Publishing Co. v. Comm'r*, 26 B.T.A. 1210 (1932).

b. Example: A policyholder paid $64,000 of premiums and the insurer subtracted $10,000 of cost of insurance charges from cash value. The policyholder then sold the policy for $80,000. The policyholder has income of $26,000, equal to the $80,000 amount realized less an adjusted basis of $54,000 ($64,000 less $14,000). Notice 2009-13, Situation 2.

c. If the income recognized on the sale or exchange of a life insurance contract exceeds the "inside build-up" under the contract, the excess may qualify as gain from the sale or exchange of a capital asset. *See, e.g.*, *Comm'r v. Phillips*, 275 F.2d 33, 36 n. 3 (4th Cir. 1960). In Notice 2009-13, Situation 2, the inside build-up was $14,000 ($78,000 cash value less $64,000 premiums paid) which is ordinary income. The excess $12,000 of the income on the sale is capital gain.

d. If a term life insurance contract is sold, the monthly premiums paid are presumed equal to the cost of insurance. Notice 2009-13, Situation 3.

4. <u>Agreement to Pay Interest</u>: If death benefits are held under an agreement to pay interest, the interest payments are taxable. Section 101(c).

5. <u>Installment Payments</u>: Death benefits may be held by the insurance company and paid in installments at later dates with interest.

   a. In such a case, the section 101(a) exclusion for death benefits applies only to the principal and not to the interest.

   b. 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).

   c. See Example #29.

6. 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.

   a. There is a similar rule applicable to universal life insurance issued before January 1, 1985. *See* section 101(f).

7. 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.” Thus, life insurance benefits paid to someone who is alive but terminally ill ordinarily would not qualify for exclusion.

b. Section 101(g), however, payments of death benefits to terminally ill and chronically ill persons are deemed paid by reason of death.

(1) An insurer may pay the death benefit before death occurs.

(2) Payments of death benefits also include the proceeds received on the sale of a policy to a viatical settlement provider. Section 101(g)(2).

c. 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).

d. Benefits received by chronically ill persons are excludible only up to specified limits. Section 101(g)(3).

e. The exclusion does not apply to benefits paid to an employer (who is not the insured) with respect to a terminally ill or chronically ill employee. Section 101(g)(5).

8. Employer Owned Life Insurance

a. Under section 101(j), if an employer owns a life insurance contract covering the life of an employee, the amount of the death benefit excluded from the employer’s income under section 101 cannot exceed the sum of the premiums and other amounts paid for the contract. Section 101(j)(1). (Like the Transfer for Value rule)

b. Section 101(j)(1) will not apply if:

(1) Notice and consent requirements (to the employee) are met, and if either:

(a) <u>Insured’s Status Exception</u>: The covered insured was an employee at any time during the 12-month period prior to death; or, when the policy was issued, was a director, a highly compensated employee, or a highly compensated individual; or

(b) <u>Payment to Insured’s Exception</u>: The proceeds (or a portion thereof) are paid to the covered employee's family, or are used to buy out an equity interest in the employer held by a family member. Proceeds paid to the family member will be ordinary income.

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 payment of premiums due, under the life insurance contract.

2. In general, a split-dollar life insurance arrangement is an arrangement under which: (Treas. Reg. § 1.61-22(b)(1))

   a. One party pays the premiums for the life insurance contract, or makes a loan to another party (secured by the CSV of the contract) that is used to pay the premiums, and

   b. One party is entitled to recover the premiums paid from the proceeds of the life insurance contract.

3. In a "compensatory" arrangement, the arrangement is entered into in connection with the performance of services, the employer pays the premiums, and the employee either designates the beneficiary or has an interest in the policy CSV. Treas. Reg. § 1.61-22(b)(2)(ii).

4. In a "shareholder" arrangement, the arrangement is entered into between a corporation and a shareholder of the corporation, the corporation pays the premiums, and the shareholder either designates the beneficiary or has an interest in the policy CSV. Treas. Reg. § 1.61-22(b)(2)(iii)(C)(2).

5. For years prior to 2002, the IRS provided rules for the treatment of split-dollar arrangements in rulings and notices:

   a. Rev. Rul. 64-328, 1964-2 C.B. 11; Rev. Rul. 67-154, 1967-1 C.B. 11; Rev. Rul. 66-110, 1966-1 C.B. 12.

   b. Notice 2001-10, 2001-5 I. R. B. 459, revoked Rev. Rul. 55-747 and issued interim guidance regarding the tax treatment of split-dollar arrangements. Notice 2002-8, 2002-4 I.R.B. 398, revoked Notice 2001-10, announced that the IRS would issue proposed regulations and provided interim guidance for split-dollar arrangements. See also Notice 2002-59, 2002-36 I.R.B. 481.

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(d) to (g) and 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. There are two alternative methods for treating split-dollar life insurance arrangements, the “economic benefit” method and the “loan” method.

b. Both methods refer to the “owner” and “non-owner” of the life insurance contract.

c. The “economic benefit” method applies to life insurance contracts where the employer is the owner of the contract.

(1) Under this method, the owner of the life insurance contract pays the premiums and is treated as providing economic benefits to the non-owner of the contract.

(2) Under this method, the employee must report the economic benefits that are provided as 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).

(3) Alternatively, depending on the relationship between the owner and the non-owner, the economic benefits that are provided may be a dividend, contribution to capital, gift, or other type of transfer. Treas. Reg. § 1.61-22(d)(1).

(4) Policyholder dividends and withdrawals are treated as paid by the life insurance company to the owner and then paid by the owner to the non-owner. Treas. Reg. § 1.61(e)(1).

(a) Amounts received by the owner are taxed in accordance with section 72.

(b) For income tax purposes amounts received by the non-owner may be compensation, a dividend, a contribution to capital, or some other type of transfer.

(5) Death benefits paid to the non-owner employee’s beneficiary are excludible under section 101(a) only to the extent that the employee paid the cost of such insurance, or to the extent that the employee took the value of current

life insurance into income as described above. Treas. Reg. § 1.61-22(f)(3). Amounts not excluded are ordinary income.

(6) *Estate of Clara M. Morrissette, et al*., 146 T.C. No. 11 (2016) (Treas. Reg. § 1.61-22's economic benefit regime, rather than loan regime, applied to post-2003 split-dollar life insurance arrangements which provided that decedent's trust would receive greater of cash surrender value of each respective policy or aggregate premium payments upon split-dollar arrangement's termination or death of insured.)

d. The "loan" method applies to life insurance contracts where the <u>employee</u> is the owner of the contract.

(1) Under this method, the non-owner pays the premiums for the life insurance contract and the non-owner is treated as loaning amounts equal to the premium payments to the owner.

(2) Under this method, the non-owner 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).

(3) 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. 2004) (Disallowing charitable deduction with respect to charitable split dollar arrangement).

8. *Our Country Home Enterprises, Inc., et al. v. Comm'r*, 145 T.C. No. 1 (2015) (In complex test cases involving purported welfare benefit plan, Tax Court determined that life insurance policies issued on the lives of employee/ shareholders were part of split-dollar life insurance arrangement.

II. Long Term Care Insurance Contracts

A. Specific rules are provided 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 provide "qualified long-term care services" (which are provided to a "chronically ill individual"), 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).

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). Section 7702B(d).

1. 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).

a. 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.

a. As to annuities issued after August 1982, withdrawals are treated as first out of the income on the contract, to the extent thereof, and then out of the investment in the contract (a "LIFO" rule). Withdrawals out of the income on the contract are included in gross income, while withdrawals out of the investment in the contract are not. Section 72(e)(B).

(1) A withdrawal is out of the income on the contact only to the extent that the current cash value of the annuity exceeds the current investment in the contract. Section 72(e)(3)(A).

(2) Thereafter, the withdrawal is out of the investment in the contract. Section 72(e)(3)(B).

(3) 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.) An exchange of annuities may result in the loss of favorable grandfather treatment.

b. Loans from the annuity are not respected as loans, but are treated as withdrawals. Section 72(e)(4).

c. In addition, policyholder dividends, as well as amounts received on surrender or redemption of an annuity contract, are treated as amounts not received as an annuity. Section 72(e)(1)(B).

d. Moreover, a penalty generally is imposed on such premature withdrawals, equal to 10% of the amount includible in income. Section 72(q). Certain withdrawals are excepted from penalty (*e.g.*, withdrawals after age 59-1/2).

e. Lastly, such contracts must contain distribution-at-death rules similar to those imposed in respect of IRAs. Section 72(s).

E. <u>Receipt of Annuity Payments</u>

1. Amounts paid under an annuity contract after the annuity starting date consist of two elements:

a. Non-taxable return of investment, and

b. Taxable investment earnings.

2. The non-taxable portion of the payment is spread over the annuity period or annuitant's life expectancy by means of an "exclusion ratio" formula. Section 72(b).

3. The "exclusion ratio" is the "investment in the contract" divided by the "expected return" under the contract, both determined 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).

(1) A refund feature refers to refunds of consideration made on or after the death of the annuitant.

(2) The value of a refund feature is determined under the Treasury Regulations.

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).

(1) In the case of a life expectancy, the expected return is determined under the Treasury Regulations.

4. Each annuity payment is multiplied by the exclusion ratio: the result is excluded from income, the remainder is included in income.

5. *See* 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. Once the investment in the contract is recovered, further annuity payments are taxable in full. Section 72(b)(2).

8. In the case of short-lived annuitants, if the annuitant dies before the investment in the contract is recovered, 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).

9. Partial annuitization.

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. If any amount is received as an annuity for 10 years or more under any portion of an annuity, that portion is treated as a separate contract. That separate contract will be allocated a portion of the investment in the contract, and there will be a new annuity starting date. Section 72(a)(2).

IV. Variable Contracts

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. Annuity contracts under which the amounts paid in or out, or life insurance contracts under which the death benefits, reflect the investment return and market value of the segregated asset account.

C. For purposes of the insurer's tax treatment:

1. The reserve for a variable contract equals the value of the assets in the account. However, for purposes of computing the increase or decrease in reserves –

a. Amounts added to reserves to reflect appreciation in value (realized or unrealized) are subtracted, and

b. Amounts subtracted from reserves to reflect depreciation in value (realized or unrealized) are added back. Section 817(a).

2. Correspondingly, the basis of assets in the account are increased to reflect appreciation and decreased to reflect depreciation.

3. Thus, due to the operation of the rules in paragraphs C and D, immediately above, the insurer is isolated from increases and decreases in the value of the variable contract's assets in the separate account.

D. Special variable contract rules for purposes of the policyholder's tax treatment:

1. First, a variable contract will not be treated as an annuity or life insurance contract unless its investments in the separate account are "adequately diversified." Section 817(h) and Treas. Reg. § 1.817-5.

a. The purpose is to avoid use of these products primarily to shield the investment income of specifically targeted investments.

b. Two diversification standards and a safe-harbor rule are provided. Treas. Reg. §1.817-5(b) & (f).

c. The general diversification test: Section 817(h)(1); Treas. Reg. § 1.817-5(b)(1)

(1) Adequate diversification exists if:

(a) No more than 55% of the value of the total assets in the account consist of any one investment,

(b) No more than 70% of the value of the total assets in the account consist of any two investments,

(c) No more than 80% of the value of the total assets in the account consist of any three investments, and

(d) No more than 90% of the value of the total assets in the account consist of any four investments.

d. The safe harbor for diversification: Section 817(h)(2); Treas. Reg. 1.817-5(b)(2).

(1) Adequate diversification exists if:

(a) The separate account meets the requirements of section 851(b)(3) (the "50% of assets test"), and

(b) No more than 55% of the value of the total assets in the account are assets described in section 851(b)(3)(A)(i) (cash and cash items (including receivables), Government securities and securities of other regulated investment companies)

e. The special diversification test for variable life insurance contracts: Section 817(h)(3); Treas. Reg. § 1.817-5(b)(3).

(1) A separate account for a variable a life insurance contract can invest in Treasury securities without limit.

(2) The non-Treasury security assets must meet the general diversification requirement, but the four percentage limitations are increased by the product of 0.5 times the percentage of the special account assets that are not Treasury securities.

(a) For example, assume 90% of the value of the separate account assets are Treasury securities and

10% are Corporation A securities. The 55 percentage limit in the general diversification rule would be increased by 45 percentage points (0.5 times 90%) to 100%.

(3) This rule is inapplicable to variable annuities.

f. Look through rules: Section 817(h)(4); Treas. Reg §. 1.817-5(f)(3).

(1) The general look-through rule applies if all of the beneficial interests in a RIC, REIT, partnership or grantor trust are:

(a) Owned by one or more insurance companies in their separate accounts (and in general accounts if other requirements are met), and

(b) Public access to the look-through entity is available exclusively through the purchase of a variable contract.

(2) If the look-through rule applies the separate account is treated as owning a pro rata share of the look-through entity's assets.

(3) *See* Rev. Rul. 2005-7. Rev. Rul. 2007-58.

g. Inadvertent failures can be corrected. Section 817(a)(2).

(1) Rev. Proc. 2008-4, 2008-2 C.B. 155, provides relief for certain contracts that fail to meet the diversification standards.

h. If the diversification standards are not met, the income on the contract is currently taxed to the policyholder. Treas. Reg. § 1. 817-5(a).

(1) 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).

(2) 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).

i. 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.

2. Second, if the contract holder has too much control over the assets in the separate account ("investor control") the contract holder, not the insurance company, will be treated as the owner of the assets for tax purposes.

a. The IRS developed the investor control rules in various revenue rulings over the years

b. The investor control requirement is not replaced by the diversification requirements, but continues to be effective. Rev. Proc. 99-44; Rev. Rul. 2003-92; Rev. Rul. 2003-91.

c. While the tests for investor control are not crystal clear, they proscribe the contract holder from:

(1) Directing the insurance company to buy or sell specific assets,

(2) Altering applicable investment guidelines,

(3) Directing, influencing or communicating with any investment advisor.

d. Investor control may not exist when the contract holder is able to direct that the separate account assets be split between various investment options. Rev. Rul. 2003-91; Rev. Rul. 82-54.

e. If the contract holder has investor control, the contract holder is treated as owning the assets directly, outside of the contract.

f. *Webber.v. Comm'r,*144 T.C. No. 17 (2015) (Webber was the actual owner of assets held in segregated accounts underlying certain life insurance policies, and, accordingly, dividends, interest, capital gains, and other income received by the special purpose company set up to hold the accounts were directly includible in Webber's gross income under §61.)

E. 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. <u>Modified Guaranteed Contracts</u>

A. Modified guaranteed contracts (MGCs) 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. Section 817A accords special treatment to these MGCs.

C. To qualify as an MGC:

1. The contract must be an annuity, life insurance contract, or pension plan contract,

2. Assets under the contract must be held in a separate account,

3. The reserves for the contract must be valued at market value on the annual statement, and

4. The contract must have a net surrender value. Section 817A(d)

D. Assets in the separate account must be marked-to-market.

1. Thus, each year the assets are treated as if sold, and any gain or loss is taken into account by the insurer as ordinary income or loss. Section 817A(a). (Any such gain or loss is excluded when the asset ultimately is actually sold.)

E. Mark-to-market gains and losses generally 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 roughly similar net results with different adjustment methods.

VI. <u>Tax-Free Exchanges Of Policies</u>

A. <u>Hypothetical situation</u>

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. <u>Taxable solution</u>

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. <u>Non-taxable solution</u>

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. <u>Qualifying exchanges Section 1035(a).</u>

1. A life insurance contract may be exchanged for a:

    a. life insurance contract,

    b. endowment contract,

    c. annuity contract, or

    d. qualified long-term care insurance contract.

2. An endowment contract may be exchanged for an:

    a. endowment contract,

    b. annuity contract, or

    c. qualified long-term care insurance contract.

3. An annuity contract may be exchanged for an:

    a. annuity contract, or

    b. qualified long-term care insurance contract.

4. A qualified long-term care insurance contract may be exchanged for a:

    a. qualified long-term care insurance contract.

5. The IRS has ruled that the exchange of <u>two</u> flexible premium life insurance contracts for <u>one</u> 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).

6. 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.

7. See PLR 201330016 (taxpayer exchanged 5 annuity contracts for a new annuity after the taxpayer had elected and started to receive life expectancy distributions from the original 5 contracts).

E. <u>Exchange Procedures</u>

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. <u>Tax Results</u>

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. <u>Cautions</u>

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.

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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. In contrast, 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 (9^{th} 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); *Burnham Corp. v. Comm'r.*, 878 F.2d 86 (2d Cir. 1989).

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 used to implement time value of money principles for the liabilities of ordinary taxpayers (defer deductions) differs from the method used for unpaid loss reserves of P&C insurers (discount current deductions).

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. In the case of workers, compensation and tort liabilities, however, section 461(h) applies and the deduction is not allowed until payments are made to the claimant. Treas. Reg. § 1.461-2(e).

4. Often, the issue presented is whether the taxpayer has "paid" what is purported to be a deductible 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).

e. In Rev. Rul. 60-275 an arrangement where the taxpayer made payments to a "reciprocal insurance exchange" was held not insurance where the total of the payments equaled the amount of coverage obtained. The payments are "nondeductible contingent deposit[s]."

f. *Com'r v. Treganowan*, 183 F. 2d 288 (2d Cir. 1950) (contributory fund that pays death benefits was life insurance).

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. 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. Under INDOPCO, the court held that the premium payments must be capitalized.

II. <u>Captive Insurance Companies</u>

A. <u>Captive insurance companies may be formed for a variety of reasons</u>

1. Nontax motives

a. To obtain insurance at lower cost

b. To insure risks that are uninsurable in conventional insurance markets.

2. Tax motive

a. 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

a. These captives issue policies to the insured and receive premiums from the insured.

2. Reinsurer captives

a. These captives assume (by reinsurance) business written by the taxpayer/insured with a direct writer, which is often referred to as the "fronting" company.

b. *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 by reinsurance to the company's wholly-owned captive insurance company).

C. The Captive Must Be an "Insurance Company"

1. Code section 816(a) provides that the term "insurance company" means "any company more than half of the business of which during the taxable year is the issuing of insurance or annuity contracts or the reinsuring of risks underwritten by insurance companies."

2. The captive must be operating as an insurance company, rather than as some other type of company, such as an investment company.

3. *See* LTRs 200809045 (premium income de minimus compared to investment income) and 200453012.

D. The Captive Must Insure Risks that are "Insurance Risks"

1. The IRS asserts that some risks are not "insurance risks."

2. The IRS's risk analysis is rooted in the Supreme Court's conclusion that whether a deposit will earn sufficient interest is an investment risk, not an

insurance risk. *Helvering v. Le Gierse*, 312 U.S. 531 (1941); *S.E.C. v. United Benefit Life Ins. Co.*, 387 U.S. 202, 211 (1967).

3. *Comm'r v. Treganowan*, 183 F.2d 288 (2nd Cir. (1950) (there is no insurance risk unless there is uncertainty or fortuitousness).

4. A contract that protects against investment risks is not insurance

   a. Rev. Rul. 89-96, 1989-2 C.B. 114: "After-loss" insurance presents only investment risk.

      (1) The insurer's risk exposure is a set amount, but the timing of the loss payment and the insurer's expected investment returns are uncertain. The insurer's risk is that insufficient investment earnings will accrue to cover its risk exposure.

      (2) FSA 200209017 (Nov. 26, 2001) (recommending application of principles of Rev. Rul. 89-96 to a situation where employer that was self-insured for 22 years obtained insurance potentially covering residual losses from the past 22 years). *See also* GCM 39795 (Apr. 15, 1982); GCM 35796 (May 1, 1974).

      (3) Note that title insurance covers the subsequent discovery of a loss event that occurred previously, before the policy was issued. Yet it is treated as insurance.

   b. Rev. Rul. 2007-47: An arrangement that pre-funds future obligations presents only investment risk.

      (1) The insured operated a business and was legally obligated to incur reclamation expenses at the end of business operations. Estimated future reclamation expenses were $300X and their present value was $150X. The insured paid a premium of $150X for coverage capped at $300X.

      (2) The ruling holds that because the obligation to pay reclamation expenses was already imposed, there was no insurance risk or hazard as to whether those expenses would be incurred. There are only timing and investment risks, not insurance risks.

      (3) In another situation, the maximum payment limit on excess loss policies issued by a captive insurance company was set at a level that was certain to be reached. Thus, there was no insurance risk, but only the risk that investment income would be insufficient. The policies

lacked risk shifting and were not insurance in its commonly accepted sense. CCA 201533011.

5. A contract that protects against normal business risks is not insurance.

   a. Rev. Rul. 68-27 (the risk of providing medical services for a fixed price is a normal business risk).

   b. PLR 9624028 involved a captive formed by 34 mutual funds to provide "break the buck" insurance, i.e., to cover the risk that net asset value would be less than $1 per share.

      (1) The insurance insured against "default risks on the assets which each of the funds held." The captive provided "coverage on insurable assets held by the funds relating to nonpayment of principal or interest, bankruptcy of the issuer or bankruptcy or insolvency of the credit enhancement provider (if any)."

      (2) The PLR referred to such events as "loss events." Each loss event would be a default by a specific individual issuer and claims paid were for the loss incurred on that specific default.

      (3) The funds represented that premiums were "based on sound actuarial principles."

      (4) The PLR holds that, based on Rev. Rul. 78-338, there is risk shifting and risk distribution, and thus insurance, due to the existence of 34 owners of the captive.

      (5) The PLR assumes but does not consider whether the insured risk is "insurance risk."

      (6) *See also* PLR 200121019 (same analysis).

6. TAM 201149021 holds that residual value insurance (RVI) provided to cover leveraged leasing transactions covers investment risk, not insurance risk.

   a. A "contract that protects against the failure to achieve a desired investment return protects against investment risk, not insurance risk."

   b. "Insurance risk requires a fortuitous event or hazard and not a mere timing or investment risk."

c. Contracts that "protect against market forces" are not insurance contracts.

(1) Note: Market forces can be moved and shaped by fortuitous events.

d. The IRS contends the risk assumed is the possibility of unexpected market forces, but the occurrence of those events is not the casualty event. While the contract is in force, unexpected events may occur but they do not create a loss. The IRS says the loss event is the termination of the contract.

e. In the TAM, the contract was long term, and the potential time gap between a market decline and the payment of a loss "creates a critical gap between those two events." Query: What if the contract were short term?

f. While market forces may create the circumstances for a loss (e.g., with mortgage guaranty insurance a decline in home value) there must be a casualty event that triggers the loss (failure to make a mortgage payment).

(1) Crop insurance is an exception, but that program is created by a federal statute.

g. Question: Has the modern market made the traditional definition of insurance obsolete?

7. See PLR 201609008, 201613016.

8. <u>Residual value insurance</u> was at issue in *R.V.I. Guaranty Co. v. Comm'r*, 145 T.C. No. 9 (Sept. 21, 2015).

a. The Tax Court held that RVI insurance does cover "insurance risk."

b. Factors: (i) is the insurer operated and regulated as an insurance company, (ii) is the insurer adequately capitalized, (iii) are the policies valid and binding, (iv) are the premiums reasonable in relation to the risk of loss, and (v) are premiums and loss claims duly paid.

c. The court rejected the IRS argument that a loss was not paid on the happening of a fortuitous event, but at the termination of the contract. The court analogized to municipal bond insurance.

d. The court rejected the argument that the contracts covered investment risk, and not insurance risk.

9. CCA 201511021 holds that insurance covering <u>foreign currency risk</u> does not constitute insurance as it does not cover "insurance risk."

   a. Insurance risk requires a "fortuitous event or hazard" and not an expected event.

   b. Investment risk and business risk are "perhaps synonymous."

   c. This is a facts and circumstances determination. A key is "whether the economic risk involved is a market risk that is part of the business environment."

   d. The CCA concludes there is no insurance risk because:

      (1) Foreign currency exchange insurance is not commonly available from major carriers. (Note that the IRS contends that lack of commercially available insurance is a factor in determining business purpose and establishing real insurance in the captive area)

      (2) The arrangement resembles a notional principal contract.

      (3) The taxpayer could purchase options to cover the currency fluctuation risk, which proves this is only investment risk. (Note: Many insured risks could be mitigated via options.)

      (4) Currency fluctuation is not "a casualty event in the commonly accepted sense." The events that can create currency fluctuations are not casualty events. (Note: A contrary position can be asserted)

      (5) Any loss is determined upon contract termination and contract termination is not a casualty event.

   e. Also, the CCA criticizes the experience rating formula utilized.

10. PLR 201609008: "When deciding that a specific contract is not insurance because it does not have an insurance risk but deals with a business or investment risk, we have considered such things as the ordinary activities of a business enterprise, the typical activities and obligations of running of a business, whether an action that might be covered by a policy is in the control of the insured within a business context, whether the economic risk involved is a market risk that is part of the business environment, whether the insured is required by a law or regulation to pay for the covered claim, and whether the action is question is willful or inevitable." PLR 201613016 (same).

11. Other rulings consider whether HMOs and extended warranty providers can be considered insurers. TAM 9601001; TAM 200827006; TAM 201117027; TAM 201438022.

E. If not "insurance," then what is the arrangement?

1. When there is no insurance, the purported "premiums" paid are not deductible. Purported "premium" payments are treated as capital contributions to the captive. "Benefits" paid by the captive are dividends to the extent of the captive's 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.

2. The IRS has commented that "an arrangement that purports to be an insurance contract but lacks the requisite risk distribution may instead be characterized as a deposit arrangement, a loan, a contribution to capital (to the extent of net value, if any), an indemnity arrangement that is not an insurance contract, or otherwise, based on the substance of the arrangement between the parties." Rev. Rul. 2005-40.

3. Option treatment is possible.

   a. In *R.V.I.* the IRS analogizes the product there "to a stock investor's purchase of a put option, which enables him to 'put' the stock to another investor if the stock falls below a specified price before the specified date."

   b. *See* Tax Notes, Volume 145, Number 7, at 791 (November 17, 2014), for a discussion of using options, in lieu of insurance contracts, to manage insurance-type risks.

      (1) As discussed in the article, the IRS view that options cannot be "conditional" would be an obstacle.

   c. Would the states regulate option-type arrangements as insurance?

F. Risk Shifting

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 IRS questions whether purported insurance shifts risk away from the insured entity, or whether the insured entity still bears the risk despite the purported insurance.

3. Parent-Subsidiary Arrangements

a. In Revenue Ruling 77-316, the IRS advanced the "economic family" concept.

(1) The theory was that all related companies are an economic family and that insurance among family members does not shift risk.

(2) In response, taxpayers have relied on *Moline Properties*, which requires that the separate identity of the parent and the captive subsidiary must be respected.

b. Between a parent and its captive subsidiary, without more, there is no insurance because there is no shifting of risk. 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, the parent has not shifted any risk of loss away from itself. (*Carnation; Clougherty; Mobil.*)

(1) In the context of parent/subsidiary captive arrangements, where no insurance is issued to unrelated third parties, courts uniformly have reached the result sought by the IRS. While rejecting the IRS's economic family theory, the courts have adopted the balance sheet test. E.g., *Clougherty Packing Co. v. Comm'r*, 811 F.2d 1297 (9th Cir. 1987).

(2) In Rev. Rul. 2001-31, 2001-1 C.B 1348 (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.

c. Lack of risk shifting continues to occur when, despite the use of a more involved structure, the relationship remains an insured parent and a captive insurance subsidiary.

(1) There is no risk shifting when the insured parent owns all the stock of a cell of a protected cell captive company, and that cell insures risks of the parent. Rev. Rul. 2008-8 (situation 1).

(2) The insertion of a fronting company does not shift risk from the parent to the subsidiary captive. (*Kidde*)

d. This does not mean there can never be "insurance" in the insured parent/captive subsidiary context.

(1) See the discussions, below, of Reinsurance, Third Party Risk, Third Party Ownership.

4. Risk Transfer by Third-Party Reinsurance

a. In an insurance arrangement, including an insured parent/captive insurer subsidiary arrangement, the portion of the risk transferred by reinsurance to an unrelated third party reinsurer (or retained by a third party fronting company) is valid insurance.

b. Revenue Ruling 77-316 (situations 2 and 3); LTR 9729002.

c. *Carnation* -- only the 10% retained by fronting company was deductible.

d. In *United Parcel Service v. Comm'r*, the IRS argued that the use of a wholly-owned offshore reinsurance company to shift income away from the U.S. parent company was a sham transaction lacking economic substance. The Eleventh Circuit held that such a transaction was bona fide and had economic effect. *United Parcel Service v. Comm'r*, 254 F.3d 1014 (11th Cir. 2001), rev'g T.C. Memo. 1999-268. See also FSA 200027008 (March 31, 2000).

e. 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, which 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.

5. Third-Party Ownership of the Captive

a. The IRS agrees that multiple ownership of the captive can create risk shifting and risk distribution.

b. At a minimum, if the parent owns X% of the captive, the IRS will say that X% of the parent's "premiums" are not insurance premiums. The remainder of the premiums qualify.

c. Moreover, if the ownership is disperse enough, the entire arrangement is valid insurance.

(1) Note: A mutual insurance company could be viewed as a "large captive" owned by its policyholders, but there obviously is risk shifting and distribution.

(2) In Revenue Ruling 80-120, 1980-1 C.B. 41, the IRS ruled that a mutual insurance exchange with 5000 policyholders involved "insurance."

(3) 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% of the total.

(4) 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.

d. *United Parcel Service* – Insurance existed because different shareholder groups owned UPS and the captive.

6. Third-Party Risk Insured by the Captive

a. The existence of third party risk can cause "risk shifting."

(1) Revenue Ruling 88-72 set forth the IRS's initial position that third party risk is irrelevant. This position was rejected by the courts, and the ruling is now obsolete. Rev. Rul. 2001-31.

b. The courts have recognized that sufficient third party risk will create risk shifting and insurance. The question is how much risk is “sufficient”?

(1) *ODECO* – The theory is that if there is a valid insurance contract, the parent’s risk is shifted to the captive. If there is third party risk at the captive, then the parent’s risk is distributed with that risk. Having the third party risk reduces the parent’s risk. The more third party risk, the more the parent’s risk is reduced.

(2) *Gulf Oil* – 2% unrelated risk is not sufficient.

(3) *Mobil* – Had third party risk, but the issue was not discussed.

(4) *Sears* – 99.75% unrelated risk is sufficient.

(5) *AMERCO* – 52-74% unrelated risk is sufficient.

(6) *Harper Group* – 30% unrelated risk is sufficient.

(7) *ODECO* – 44-64% unrelated risk is sufficient.

c. For the IRS, what level of outside, third party risk is enough?

(1) 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.

(2) 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.

7. Brother-Sister Relationships

a. If a parent owns an operating subsidiary and a captive insurance subsidiary, is there "risk shifting" from the insured to the insurer?

(1) Applying the "balance sheet" test, the Sixth Circuit 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).

(a) 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 that insurance exists in a number of captive arrangements involving brother/sister entities. See, e.g., FSA 200029010 (April 24, 2000); FSA 200043012 (June 19, 2000); FSA 200105014 (Oct. 26, 2000).

(5) Rev. Rul. 2002-90, 2002-2 C.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) Rev. Rul. 2008-8 – same result where the wholly owned captive is a protected cell captive company.

(7) *Kidde* – the court rejected the IRS theory that you look to whether the parent's shareholders have their risk reduced.

The court held the key is whether the parent of the captive has its risk reduced under the balance sheet test, not the parent's shareholders.

(a) The IRS argument was a disguised reassertion of the economic family argument.

(b) Two deciding factors determine the issue: (i) *Moline Properties*, and (ii) balance sheet test.

(8) In *Rent-A-Center v. Comm'r*, 142 T.C. No. 1 (2014) (the Tax Court accepted the brother/sister result).

(a) *See also, Securitas* – Insurance existed, based on the balance sheet and net worth analysis.

(9) Rev. Rul. 2005-40, 2005-2 C.B. 4

(a) Situation 4, in which a captive insures 12 LLC's taxed as associations, insurance exists, citing Rev. Rul. 2002-90.

(b) In Situation 3, however, each of the 12 LLCs is a disregarded entity. Accordingly, the captive insurer provides insurance only to the parent, and there is no insurance.

(10) To achieve risk distribution, how many "brothers/sisters" are required?

(a) *Gulf Oil* – there must be sufficient unrelated risks in the pool for the law of large numbers to operate.

(b) *Humana* – there were 22-48 insured subsidiaries

(c) *Malone & Hyde* – there were 8 insured subsidiaries, with diverse risks (workers comp, auto, general liability)

(d) Revenue Ruling 2002-90 – 12 insured subsidiaries are enough. See also Rev. Rul. 2005-40.

(e) LTR 200724036 – 5 insureds in one year, 7 in another year.

(11) If the insurer insures third party risks, the brother/sister insured's risk might be distributed with those third parties.

(a) *Gulf Oil*

(b) *Humana* (footnote 4)

(12) What if there is only one brother/sister insured, but that brother/sister insures different types of its risks?

(a) *Gulf Oil* – a single insured can have sufficient unrelated risks to achieve adequate risk distribution. FSA 1998-167 (same).

(b) *Malone & Hyde* (Tax Court) – If there are multiple and diverse risks, there is risk distribution where there are 8 subsidiaries (dicta quotes language saying there is distribution regardless of the number of insureds)

(c) See Rev. Rul. 2005-40, discussed in the context of risk distribution, below.

(d)

(e)

(f) The risk distribution analysis in *Rent-a-Center* and *Securitas*, see below, may support the contention that the number of insured entities is irrelevant, albeit the Tax Court did not address the single insured entity issue.

(13) Contrary to Rev. Rul. 2005-40, which analyzes risk distribution by looking to the number of insured entities, two 2014 and one 2015 Tax Court cases analyzed whether there was a sufficient number of statistically independent risks, rather than a sufficient number of insured entities. The IRS did not appeal either decision.

(a) *Rent-a-Center* – 4 to 12 insureds. Risk units comprised 2,400 stores, 14,000 to 20,000 employees, 2,400 vehicles. The Tax Court looked to the number of risk units, not to the number of insureds exposed to those risks.

(b) *Securitas* – 4 to 11 insureds, 90% of risk concentrated in 4 insureds. The Tax Court looked to the number of risk units, not to the number of insureds exposed to those risks.

(c) *RVI* – the court applied a risk unit analysis.

(14) Rev. Rul. 2005-40 rules that subsidiaries that are disregarded entities are not recognized. Rather, the risks and premiums of the disregarded entity are those of the parent.

G. Distribution of Risk

1. The IRS states that to have insurance, there must be not only risk shifting but also risk distribution.

2. The IRS has taken a hard line on what constitutes risk distribution. The analysis assumes the insurance company must have multiple insureds.

a. Question: If a billionaire sells you a "policy" under which she will pay your claim if you incur a loss, and that is the billionaire's only such policy, is this insurance?

(1) IRS: No, there is no risk distribution, because there is only one policyholder. Rev. Rul. 2005-40, Situation 1.

(2) Query: Why is this not insurance?

3. One basic concept is that risk distribution exists if the assumed risks are "independent" rather than "interdependent." TAM 201149021. Insurance policies exposed to the "same flood risk" because all the insured properties were located on the same flood basin do not distribute risk. Rev. Rul. 60-275.

a. The Service contends that risk distribution is lacking when the same market forces could impact the insured assets. TAM 201149021.

4. PLR 201219011: "Risk distribution incorporates the statistical phenomenon known as the law of large numbers. Distributing risk allows the insurer to reduce the possibility that a single costly claim will exceed the amount taken in as premiums and set aside for the payment of such a claim. By assuming numerous relatively small, independent risks that occur randomly over time, the insurer smooths out losses to match more closely its receipt of premiums."

5. Rev. Rul. 2002-90, Rev. Rul. 2002-89, Rev. Rul. 2008-8 and Rev. Rul. 2005-40 note that the risks are "homogenous." Rev. Rul. 2002-91 (all insureds are in "one highly concentrated industry"); FSA 1998-578.

a. However, heterogeneous risks may also distribute risk.

b. If the captive insures various lines of business, homogeneity can be determined on a line-by-line basis. FSA 1998-578.

6. Rev. Rul. 2008-8 ("Risk distribution occurs when the party assuming the risk distributes its potential liability among others, at least in part.")

7. Rev. Rul. 2009-26 (distribution of risk in the reinsurance context).

8. Rev. Rul. 2002-89: Third party risk creates risk distribution

a. Situation 1: Parent's premiums are 90% of the captive's total risks; remaining 10% of premiums are from unrelated parties. No risk distribution.

b. Situation 1: Parent's premiums are less than 50% of the captive's total risks; over 50% of premiums are from unrelated parties. Adequate risk distribution.

9. <u>Rev. Rul. 2002-90:</u> Captive insures 12 brother/sister operating companies, and risk distribution is adequate. Rev. Rul. 2008-8, Situation 2 (same).

10. <u>Rev. Rul. 2005-40</u>: Focuses on risk distribution

a. Situation 1: Captive issues only one insurance policy to only one policyholder.

(1) Even though risk is shifted, there is no risk distribution. . See also PLR 200715012 (Jan. 11, 2007) and PLR 200724036 (March 20, 2007).

(2) This is contrary to *Gulf Oil* and to FSA 1998-167.

b. Situation 2: Same facts as situation 1, except that one additional policy is issued to one third party, resulting in 10% third party risk

(1) No risk distribution, per Rev. Rul. 2002-89

c. Situation 3: Captive issues policies to12 brother/sister operating subsidiary LLCs that are disregarded entities.

(1) Since the 12 LLC's are disregarded, the insured entity is the parent. Thus, the result is the same as Situation 1 – there is no risk distribution with only one policyholder.

d. Situation 4: Same facts as Situation 3, except that the 12 operating subsidiary LLCs are not disregarded entities

(1) Same facts as Rev. Rul. 2002-90 and Rev. Rul. 2008-8 – risk distribution exists.

11. Does this view of risk distribution make sense?

    a. Assume an insurer insures 10,000 automobiles.

    b. If all automobiles are owned by various individuals, the IRS says there is risk distribution.

    c. If all the automobiles are all owned by Hertz, the IRS says there is no risk distribution.

12. Contrary to Rev. Rul. 2005-40, etc., which analyze risk distribution by looking to the number of insured entities, three 2014/2015 Tax Court cases analyze whether there was a sufficient number of statistically independent risks ("risk units") rather than a sufficient number of insured entities. The IRS lost and did not appeal these decisions.

    a. Note, however, that these three cases did not address the situation where the captive issued only one policy to only one policyholder.

    b. *Rent-a-Center* (2014) – The captive insured 4 to 12 entities. The insured risk units comprised 2,400 stores, 14,000 to 20,000 employees, 2,400 vehicles. The Tax Court looked to the number of risk units, not to the number of insureds exposed to those risks. The Tax Court looked to the number of risk units, not to the number of insureds exposed to those risks. *I.e.*, do the insureds have a sufficient number of statistically independent risks? The focus was on the number of stores, employees and vehicles.

    c. *Securitas* (2014) – The captive insured 4 to 11 entities, with 90% of insured risk concentrated in 4 insureds. Five types of risks covered 200,000 people in 20 countries, and 2,250 vehicles. The Tax Court determined risk distribution from the insurer's perspective. As a result of the large number of employees, offices, vehicles and services there was a large pool of statistically independent risk exposures. Again, the focus was on risk units, not which insured entity owned the risk. Where the risk units were located was not relevant.

    d. *RVI* (2015) – The insurer had 951 policies covering 714 different insured parties. "Besides being spread among numerous unrelated insureds, its risks were distributed in at least four ways: across business segments…, across asset types within each segment, across geographic locations…, and across lease duration."

        (1) This is a risk unit analysis.

        (2) The IRS claimed market forces might impact all insured assets simultaneously. The court found that the risks were

uncorrelated. The court stated that "perfect independence of risks is not required."

H. <u>Other factors that will prevent the arrangement from being treated as "insurance"</u>

1. Disqualifying factors discussed above are: (a) lack of insurance risk, (b) lack of risk shifting, and (c) lack of distribution of risk.

2. <u>Lack of business purpose</u>

   a. Hold over from "tax shelter" attitude of captive insurance?

   b. Held OK – *Humana* (loss of commercial insurance possibilities was a valid business purpose); *ODECO* (loss of commercial insurance possibilities); *Kidde.* Rev. Rul. 2002-90. Rev. Rul. 2002-91 Affordable insurance coverage not available).

   c. Held not OK – *Malone & Hyde* (no legitimate purpose).

3. <u>Sham</u> (an aggregation of factors separately discussed below).

   a. *Humana; Kidde* – If a sham, can disregard the separateness of the identities that otherwise would exist under Moline Properties.

   b. Held OK – *Humana* (valid company; regulated); *ODECO* (unrelated risk; commercial insurance rates; adequate capital; business separate from parent's business); *Rent-a-Center* (business purpose, no circular cash flow).

   c. Held not OK – *Malone & Hyde* (is a sham if there is undercapitalization and parent guarantees).

   d. *Rent-a-Center* – No sham where captive formed for non-tax business purposes and there was no circular cash flow.

   e. *Ax v. Comm'r,*146 T,C. No. 10 (2016).

4. <u>Lack of technical risk shifting</u>

   a. There must be bona-fide insurance contracts that transfer risk. (*Malone & Hyde* (Tax Court); *ODECO; Kidde*).

5. <u>Inadequate capitalization</u>

   a. Held OK – *Sterns-Roger* (adequately capitalized); *Humana* (fully capitalized); *ODECO* (adequate); *Rent-a-Center* (adequate). Rev. Rul. 2005-40. Rev. Rul. 2002-91.

b. Held not OK – *Carnation* (under capitalized); *Beech* (under capitalized); *Gulf Oil* (undercapitalized); *Malone & Hyde* (had the minimum required by Bermuda law).

c. *Securitas* – Analyzed the issue using premium-to-surplus ratio; reinsurance reduced need for capital.

6. Proper conduct of insurance operations

a. Also called "insurance in the commonly accepted sense."

b. Rev. Rul. 2002-89 – the parties must conduct themselves consistently with insurance industry standards applicable to unrelated parties and proper business records must be maintained.

c. Rev. Rul. 2002-91 – captive investigates claims before paying benefits and the captive's business operations are kept separate from the business operations and assets of the insureds.

d. *Rent-a-Center* – The captive need not operate exactly like a commercial carrier.

e. *Securitas* – Factors to be considered are: organization, operation and regulation as an insurance company; adequate capitalization; valid and binding insurance policies; reasonable premiums; payment of premiums and losses.

7. Hold harmless, guarantee or indemnification agreements

a. Held OK – *Humana* (no agreement). Rev. Rul. 2005-40 and Rev. Rul. 2002-89 (no guarantee of any kind)

b. Held not OK – *Sterns-Roger* (indemnification agreement); *Gulf Oil* (no risk shifting since parent issued guarantees to the fronting companies); *Malone & Hyde* (hold harmless agreements indicate that there was no risk shifting); *Kidde* (indemnity agreement); *HCA* (guaranty to third party fronting insurer prevented risk shifting).

c. *Rent-a-Center* – Parent guaranty did not vitiate risk shifting; captive not undercapitalized; guaranty issued for regulatory purposes; guaranty not issued to unrelated insurer.

d. *Securitas* – Parent guaranty did not vitiate risk shifting; captive not undercapitalized; guaranty not issued to unrelated insurer.

8. <u>"Loan back" provisions</u> (investment in the parent)

   a. *ODECO* (captive never invested in parent's or its subsidiaries' securities, and never loaned money to the parent or its affiliates)

   b. Rev. Rul. 2002-89 and Rev. Rul. 2005-40 (no loan back). FSA 200202002.

   c. FSA 199945009 (loan to a finance affiliate not insured by the captive may be acceptable).

9. <u>Non-arm's length premiums</u>

   a. Premiums should be established using "customary industry rating formulas." Rev. Rul. 2005-40; Rev. Rul. 2002-91; Rev. Rul. 2002-90; Rev. Rul. 2002-89; Rev. Rul. 2008-8. FSA 200202002.

10. <u>Inadequate premium allocations</u>

   a. If the parent pays the premium to the captive and allocates the portions of the premium charged back to other subsidiaries, the IRS will argue that a haphazard allocation will defeat the existence of risk shifting (*Malone & Hyde* – Tax Court)

   b. *Securitas* – Use of journal entries rather than "cutting checks" is permissible; entities kept complete and accurate journal entries.

11. <u>Experience rating</u>

   a. The IRS will make its usual arguments that experience rating means that there is no transfer of risk (see *Sears*; *Camelot*; *AEP*)

   b. Rev. Rul. 2002-91 and Rev. Rul. 2005-40 (no experience rating)

I. <u>Captives in Consolidated Groups</u>

1. Consolidation does not defeat risk shifting

   a. *ODECO; Kidde*.

2. Prop. Treas. Reg. § 1.1502-13(e)(2) provided that if a captive insures risks of other members in the consolidated group, and if those risks exceed 5% of the total risks insured by the captive, the unearned premium and unpaid loss reserves are disallowed. The regulation, proposed in 2007, was withdrawn

3. This would disallow brother/sister captive insurance in the group, and would raise the level of third-party risk required to 95%.

J. 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.

K. 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).

L. Section 953(d) allows foreign captives to elect to be taxed as domestic corporations.

1. 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.

2. 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.

4. Section 4371 excise taxes do not apply to second level reinsurance policies and wholly foreign retrocessions purchased from other foreign insurance companies and retrocessionaires. Validus Reinsurance, Ltd. v. United States, 786 F.3d 1039 (D.C. Cir, 2015). Rev. Rul. 2016-3 (accepting the result in Validus)

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).

EXPERIENCE METHOD – EXAMPLE #1

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

A. 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

B. 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

C. 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

EXPERIENCE METHOD – EXAMPLE #2

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

A. 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

B. 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

C. 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

BANK BECOMES “LARGE BANK” – EXAMPLE #3

Assume:

1. Prior to 2009, 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 2009, Bank only made loans to businesses located in Maryland.

4. In 2009, the basis of Bank’s assets increased to $520 million.

5. In 2009, Bank made no new Maryland loans, but began to make loans to businesses located in New Jersey.

6. In 2009, Bank charged off as worthless $2 million of Maryland loans and $1 million of New Jersey loans.

7. 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:

> Option 1: Bring the $20M year-end reserve balance into income as a section 481 adjustment 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.
>
> Option 2: Use the elective cut-off method.
>
> For Maryland 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 Maryland loans, the excess is income.
>
> Under this option, the deduction equals the $1M charge off of New Jersey loans.

THRIFT BECOMES A "LARGE BANK" IN 1996 – EXAMPLE #4

A. 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

B. 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

THRIFT BECOMES A "SMALL BANK" IN 1996 – EXAMPLE #5

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 continued 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:

The thrift then ceases to be a bank.

Bring $80 fresh start amount into income ratably over 6 years

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<u>PRORATION (SECTION 291) – EXAMPLE #6</u>

Assume

1. T/E obligation acquired in 1984
2. Basis of such tax-exempt obligations is $20 M
3. Basis of all assets is $100 M

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

$2 M of interest expense is “allocable to”

Thus, 20% of the $10M interest expense or $2 M is “allocable to”

Rule: Disallow 20% of interest “allocable to” these T/E, or $400,000

PRORATION (SECTION 265) – EXAMPLE #7

Assume

1. T/E obligation acquired in 1988

2. Basis of such tax-exempt obligations is $20 M

3. Basis of all assets is $100 M

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

$2 M of interest expense is "allocable to"

Thus, 20% of the $10M interest expense or $2 M is "allocable to"

Rule: Disallow 100% of interest "allocable to" these T/E, or $2 M

PRORATION – EXAMPLE #8

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% to 5%.

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% 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% 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%, so 40% 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

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FORECLOSURES – EXAMPLE #9

	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

RIC SOURCE OF INCOME REQUIREMENT – EXAMPLE #10

	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%

RIC INVESTMENT REQUIREMENTS – EXAMPLE #11

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% of RIC assets per corporation)	40
	100

The RIC owns 10% of the stock of Corporation A.

The RIC owns 20% of the voting stock of Corporation B, and less than 10 percent of the voting stock of the other corporations.

The RIC has 75% of its assets invested in compliance with the 50% test of section 851(b)(3)(A).

RIC INVESTMENT REQUIREMENTS – EXAMPLE #12

l. A section 851(e) venture capital RIC, on March 31, 1990, purchases 1,000 shares of Research Corp. stock (100% 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% of the value of its total assets.

The stock is counted for purposes of computations under the 50% 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% of the value of its total assets.

However, the basis of those shares ($60,000) is only 4% of the value of total assets as of March 31, 1998.

Thus, the investment is counted in computations under the 50% test of section 851(b)(3)(A), as modified by section 851(e).

RIC INVESTMENT REQUIREMENTS – EXAMPLE #13

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% 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% of both Corporations B and C. The section 851(b)(3)(B) test is failed.

Part C: Assume that Corporation A has invested 25% of its assets in Corporation X, which in turn has invested 25% of its assets in Corporation C. The RIC has directly invested 25% of its assets in corporation C. The RIC-A-X-C chain of corporations is connected through 20% stock ownership. The RIC is deemed to have invested another 1.25% (20% of 25% of 25%) of its assets in Corporation C indirectly. Thus, the section 851(b)(3)(B) test is failed.

REIT INCOME REQUIREMENTS – EXAMPLE #14

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

REIT INVESTMENT REQUIREMENTS – EXAMPLE #15

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% (by voting power and value) of the outstanding securities of Corporation A and 10% (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% of its assets invested in compliance with section 856(c)(4)(A).
- Not more than 25% 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)(iv) test.
  - Except for government securities and the securities of a taxable REIT subsidiary, the REIT does not have over 5% 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% 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% test.

REIT DISTRIBUTION REQUIREMENTS – EXAMPLE #16

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

REIT TAXATION – EXAMPLE #17

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% 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

CLOSED CASE METHOD OF TESTING UNPAID LOSS RESERVES – EXAMPLE #18

Year under examination - 2016

The test will examine unpaid loss reserves for cases that are open as of the end of 2009, 2010, and 2011.

The test will divide those cases into two groups: those that have been closed as of 2016, and those that still remain open as of 2016.

As to cases closed during that development period, the test will determine the payments made on those cases through 2016. 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 2016, during the year of:

Test Year	2010	2011	2012	2013	2014	2015	2016
2009	$1,000	$1,800	$1,100	$3,000	$ 300	$ 500	$ 700
2010		$1,900	$1,600	$2,300	$ 800	$1,000	$ 500
2011			$2,000	$2,500	$1,900	$1,200	$ 500

Test Year	Loss Reserve	Total Payments	Experience Rate
2009	$8,900	$8,400	106%
2010	$9,400	$8,100	116%
2011	$9,000	$8,100	111%

111% = Average experience rate

Unpaid Loss Reserve claimed for 2016 = $15,000

Allowable reserve ($15,000 / 1.11) = $13,513

Audit adjustment $ (1,487)

AGE-TO-ULTIMATE METHOD OF TESTING UNPAID LOSS RESERVES – EXAMPLE #19

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.

RESERVES FOR UNEARNED PREMIUMS – EXAMPLE #20

Assume that a P&C insurer has the following unearned premium reserves:

Year End	Reserve	80% of Reserve
12/31/2015	$1,000,000	$ 800,000
12/31/2016	1,200,000	960,000
12/31/2017	1,500,000	1,200,000

Year 2016

A. The increase in the reserve for unearned premiums ($200,000) is reduced by 20%, or $40,000. Thus, only 80% of the reserve increase, or $160,000, is deductible.

Year 2017

A. The increase in the reserve for unearned premiums ($300,000) is reduced by 20%, or $60,000. Thus, only 80% of the reserve increase, or $240,000, is deductible.

LOSSES INCURRED – EXAMPLE #21

Assume: $500,000 losses paid during 2013.
$100,000 salvage and reinsurance recovered during 2013.

Assume: $800,000 tax-exempt interest received during 2013.

Assume:

Year End	Unpaid Losses	Unpaid LAE
12/31/2012	$1,000,000	$100,000
12/31/2013	1,300,000	200,000

Assume:

Year End	Estimated Salvage Recoverable
12/31/2012	$300,000
12/31/2013	400,000

Note: The amounts shown above have not been discounted.

Computation of "Losses Incurred" for the Year 2013:

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 (12/31/2012) and $1,500,000 (12/31/2013).

C. Unpaid loss reserves must be discounted. Assume that for 2012 and 2013 the discounting reduces the reserves by 20%:

Year End	Undiscounted Reserve	Discounted Reserve	
12/31/2012	$1,100,000	$880,000	
12/31/2013	1,500,000	1,200,000	
		$ 320,000	$320,000

D. Estimated salvage recoverable must be discounted. Assume that for 2012 and 2013 the discounting reduces the estimate by 20%:

Year End	Undiscounted Estimate	Discounted Estimate	
12/31/2012	$300,000	$240,000	
12/31/2013	400,000	320,000	
		$80,000	($ 80,000)

E. Tentative losses incurred $640,000

F. Reduce the tentative deduction by 15% of tax-exempt interest.

$800,000
15%
$120,000

($120,000)

G. Losses incurred - $520,000

PROPERTY/CASUALTY INSURANCE COMPANY TAXABLE INCOME –
EXAMPLE #22

During the year 2018, 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 2018, the company also received recoveries of salvage (attributable to its automobile insurance line of business) totaling $4,000,000.

During the year 2018, the company paid to its policyholders insurance claims totaling $20,000,000, and paid expenses totaling $31,000,000. During 2018, the company also paid premiums on reinsurance policies in the amount of $300,000.

As of the end of the year 2017 and the end of the year 2018, 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
2017	$200,000,000	$50,000,000	$ 80,000,000
2018	$300,000,000	$40,000,000	$100,000,000

For the year 2018, 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.

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RESERVE THEORY – EXAMPLE #23

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

PRORATION – EXAMPLE #24

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.

PRORATION – EXAMPLE # 25

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% 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% = $5,600,000

DEFERRED ACQUISITION COSTS – EXAMPLE #26

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).

EMPLOYER GROUP TERM LIFE INSURANCE – EXAMPLE #27

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 2016.

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 $1,000 of coverage for a year ($.15 times 12)	$1.80
6.	Number of $1,000s of coverage subject to tax	x 15
7.	Cost of policy includible in employee’s income (15 times $1.80)	$27.00

MODIFIED ENDOWMENT CONTRACTS – EXAMPLE #28

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.

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LIFE INSURANCE DEATH BENEFITS – EXAMPLE #29

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.

ANNUITY WITHOUT REFUND FEATURE – EXAMPLE #30

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

ANNUITY WITHOUT REFUND FEATURE – EXAMPLE #31

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.

ANNUITY WITH REFUND FEATURE – EXAMPLE # 32

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% 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.

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TAX-FREE POLICY EXCHANGES – EXAMPLE #33

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	