

IRS Hot Topics

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IRS provides insurers with safe harbor for some bad debt deductions

The Large Business and International (LB&I) Division of the Internal Revenue Service released an Industry Director Directive (IDD) allowing insurance companies to elect what is effectively a safe harbor for partial worthlessness deductions with respect to loan backed and structured securities as defined in Statement of Statutory Accounting Principle (SSAP) 43R. The new safe harbor is patterned after the safe harbor under Treas. Reg. Section 166-2(d). Taxpayers are permitted to make this one-time election going back to the 2009 taxable year, through the 2012 taxable year, with a true-up adjustment and full audit protection for years prior to, and including, the year of election.

An IDD provides administrative guidance to LB&I examiners to ensure consistent tax administration and on

matters relating to internal operations. IDD's do not establish Service position on legal issues and are not legal guidance.

Background

The economic downturn impaired the value of many securities held by insurance companies, including REMIC regular interests. The primary tax issue addressed by the IDD is how insurance companies should account for the impairments to these securities.

The safe harbor method prescribed by the IDD requires conformity with the statutory accounting treatment for impairment of loan-backed securities for which a deduction would be allowed under Section 166. The safe harbor method requires that, except to the extent of any market-related



impairment, post-impairment tax basis will equal post-impairment statutory carrying value.

Qualification requirements

Specifically, the IDD conforms the meaning of a charge-off for tax purposes to statutory accounting principles, i.e., a write-down of securities carrying value is treated as a realized loss or a charge to the statement of operations (as opposed to recognition of an unrealized loss) for statutory accounting purposes. Moreover, the IDD requires that to qualify, the security must meet the definition of an 'eligible security' as that term is defined in SSAP 43R. Among the additional requirements for qualification are the following:

- The company must be regulated by a state or the District of Columbia as an insurance company and subject to taxation under Subchapter L of the Code.
- The company must file an Annual Statement for which the regulator has Examination authority.
- The company must charge the debt off on its Annual Statement.

For the IDD to apply, an insurance company must use the SSAP 43R credit-related impairment charge-off amount for all eligible securities that are partially worthless. In other words, the safe harbor method

prescribed by the IDD must be applied to all eligible securities and cannot be applied on a security-by-security, or debt-by-debt, basis.

Determining the amount of bad debt deduction

Under the IDD safe harbor method, the company's partial worthlessness deduction under Section 166(a)(2) for eligible securities is equal to the company's SSAP 43R credit-related impairment charge-offs for the same securities as reported on its Annual Statement except that the company reduces or increases its deduction by a positive or negative adjustment. The positive or negative adjustment is determined on December 31 of the first year in which the taxpayer applies the IDD safe harbor method. The adjustment is the difference between:

- The tax basis of eligible securities
- The statutory carrying value of the same securities increased by any non-credit-related portion of any charge-off not allowed as deductible under the IDD

The tax basis of eligible securities may not be less than the post-charge-off statutory carrying value under SSAP 43R as adjusted for any non-credit impairment. The IDD acknowledges that the deduction in the first year in which the IDD is applied, i.e., the 'adjustment year,' may be negative

depending on the size of a negative adjustment and therefore, may be an item of income.

Subsequent adjustments

Subsequent adjustments will typically conform to the Annual Statement. Accordingly, for years after the first year in which the IDD is applied, the taxpayer's partial worthlessness deduction under Section 166(a)(2) for eligible securities will be the same amount as the taxpayer's SSAP 43R credit-related impairment charge-offs for the same securities as reported on its Annual Statement. In no event may the tax basis of eligible securities be less than the post-charge-off statutory carrying value under SSAP 43R as adjusted for any non-credit impairment.

The IDD does not address post-impairment accretion of market discount.

Election procedures and transition rules

Under Examination

The IDD contemplates two methods for implementation with respect to taxpayer's under Examination for the year in which the taxpayer decides to apply the IDD safe harbor method. The IDD makes clear that the decision with respect to implementation should be a collaboration between the

taxpayer and the LB&I examiners. One method discussed in the IDD is to change the amount of the taxpayer's partial worthlessness deduction for eligible securities for the taxable year(s) under Examination to be consistent with the IDD. The other method is to allow the taxpayer to file amended federal income tax returns.

If a taxpayer, under Examination, uses its SSAP 43R credit-related impairment charge-offs as the amount of its partial worthlessness deduction under Section 166(a)(2), it must sign and complete a Certification Statement. A sample Certification Statement is attached to the IDD, *IRC Section 166: LB&I Directive Related to Partial Worthlessness Deduction for Eligible Securities Reported by Insurance Companies*. The entire Certification Statement must be completed to apply the safe harbor prescribed by the IDD. The Certification Statement must be signed by an individual who is authorized to execute the taxpayer's federal income tax return for the taxable year under audit. The individual must certify, under penalty of perjury that, for the taxable year under audit, the taxpayer's SSAP 43R credit-related impairment charge-off for eligible securities reported on its Annual Statement are consistent with the Section 166(a)(2) partial worthlessness deduction claimed for the same eligible securities.

A separate certification statement may be required for each insurance company filing as a member of a federal consolidated group. Any taxpayer not in compliance with the above described requirements will be ineligible to apply the IDD safe harbor and subject to regular audit procedures.

Not under Examination

If a taxpayer is not under Examination, it may file amended federal income tax returns or it may choose to apply the IDD with respect to its current taxable year. In either case, taxpayer must attach a statement to its federal income tax return for the first year in which it applies the IDD, i.e., the 'adjustment year,' stating that it is implementing the provisions of the IDD beginning in that adjustment year. Accordingly, a taxpayer may make the election by attaching such a statement to its 2011 Form 1120-L or Form 1120-PC, provided that the taxpayer has not already filed its 2011 federal income tax return. A separate statement should be attached for each insurance company that is a member of a consolidated group.

Whichever election procedure is used, a taxpayer should retain underlying accounting documentation that would permit examiners to reconcile the taxpayer's Annual Statement with any partial worthlessness deductions for eligible securities reported on its federal income tax return.

PwC observations

This IDD is the first insurance related project to successfully reach resolution through the Industry Issue Resolution (IIR) program. The IIR program is designed to resolve frequently disputed or burdensome tax issues that affect a significant number of business taxpayers through the issuance of guidance. For each issue selected for the program, a resolution team is assembled, including personnel from the IRS, Office of Chief Counsel and Treasury. Recently, the IRS accepted another insurance issue into the IIR program concerning the proper tax accounting treatment of hedges, specifically with respect to guaranteed variable annuities.

The IDD adds needed conformity with respect to the treatment of these securities for statutory and tax purposes. The IDD allows affected taxpayers to keep one set of records rather than separate records for book and tax.

The IDD relieves both insurance company taxpayers as well as personnel with the IRS, LB&I Examination Division of the burden of having to determine independently partial worthlessness amounts under Section 166.

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