

I.R.C. §166: LB&I Directive Related to Partial Worthlessness Deduction for Eligible Securities Reported by Insurance Companies

LB&I Control No: LB&I-4-0712-009
July 30, 2012

MEMORANDUM FOR:
INDUSTRY DIRECTORS
DIRECTOR, FIELD SPECIALISTS
DIRECTOR, PREFILING AND TECHNICAL GUIDANCE
DIRECTOR, INTERNATIONAL BUSINESS COMPLIANCE

FROM:
Heather C. Maloy /s/ Heather C. Maloy
Commissioner, Large Business & International Division

SUBJECT:
I.R.C. §166: LB&I Directive Related to Partial Worthlessness Deduction for Eligible Securities Reported by Insurance Companies

This Directive provides that Large Business & International (LB&I) examiners should not challenge an insurance company's partial worthlessness deduction under §166(a)(2) for the amount of the Statement of Statutory Accounting Principle (SSAP) 43R credit-related impairment charge-offs of eligible securities as reported on its Annual Statement. Independently determining partial worthlessness amounts under section 166 imposes a significant burden on both insurance companies and LB&I. If an insurance company claims a section 166(a)(2) partial worthlessness deduction for eligible securities, but does not meet the requirements of this Directive, regular audit procedures will apply.

This Directive is not an official pronouncement of law, and cannot be used, cited, or relied on as such. In addition, nothing in this Directive should be construed as affecting the operation of any other provision of the Code, regulations or guidance thereunder.

Background:

Section 166(a)(2) provides that "[w]hen satisfied that a debt is recoverable only in part, the Secretary may allow such debt, in an amount not in excess of the part charged off within the taxable year, as a deduction."

Insurance companies are required by state law to file Annual Statements using the accounting principles set out in the National Association of Insurance Commissioners (NAIC) Accounting Practices and Procedures Manual which have been adopted by the states. SSAP 43R provides accounting rules that must be followed when loan-backed and other structured securities are impaired and subject to a charge-off. SSAP 43R became effective on September 30, 2009, and applies for all reporting periods ending on or after September 30, 2009.

Definitions:

"Annual Statement" means the annual statement approved by the NAIC which an insurance company is required to file with insurance regulatory authorities of a state.

"Charge-off" means an accounting entry or set of accounting entries that reduce the debt's carrying value and results in a realized loss or a charge to the statement of operations (as opposed to recognition of an unrealized loss) that is recorded on an insurance company's Annual Statement.

"Eligible securities" means investments in loan-backed and structured securities within the scope of SSAP 43R, subject to section 166, and not subject to section 165(g)(2)(C), including Real Estate Mortgage Investment Conduit (REMIC) regular interests.

"Insurance company" means a life insurance company (as defined in section 816(a)) or a non-life insurance company (as defined in section 831(c)) that is subject to regulation as an insurance company, that is subject to taxation under Subchapter L of the Code, and that files an Annual Statement for which a state regulator has examination authority.

Issue Tracking:

Any cases having this issue should use the following ITAC tracking code:
ITAC 4166: LB&I Directive on I.R.C. § 166(a)(2) -- Partial Worthlessness Deduction for Eligible Securities Reported by Insurance Companies.

Examination Guidance:

A. In General

LB&I examiners should not challenge an insurance company's partial worthlessness deduction under §166(a)(2) for eligible securities if the company complies with the following:

1. First Year Adjustment

For the first taxable year in which an insurance company applies the provisions of this Directive (the "Adjustment Year"), which can be no earlier than the company's 2009 and no later than the company's 2012 taxable years, the company's partial worthlessness deduction under § 166(a)(2) for eligible securities is the same amount as 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 Adjustment Year and is the difference between (i) the tax basis of eligible securities over (ii) the statutory carrying value of the same securities increased by any non-credit-related portion of any charge-off not allowed as deductible under this Directive. 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 Adjustment Year partial worthlessness deduction may be negative depending on the size of a negative adjustment, and therefore may be an income item; and

2. SSAP 43R Credit-Related Charge-Off Conformity

For taxable years beginning after the Adjustment Year, the insurance company's partial worthlessness deduction under § 166(a)(2) for eligible securities is the same amount as the company'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.

If an insurance company complies with both 1. and 2. above, LB&I examiners should not challenge an insurance company's partial worthlessness deduction under §166(a)(2) for eligible securities as reported on its Federal income tax returns for all open years ending before the Adjustment Year.

B. Implementation

1. Under Examination.

If an insurance company is under examination and wants to apply the provisions of this Directive, LB&I examiners, in consultation with the company, will decide whether the most appropriate way to implement this Directive is to change the amount of the company's partial worthlessness deduction for eligible securities for the taxable year(s) under examination to be consistent with this Directive or allow the company to file amended Federal income tax returns. See paragraph A.1. for the time period in which an insurance company may choose to implement this Directive.

2. Not Under Examination.

If an insurance company is not under examination, it may choose to implement the provisions of this Directive by filing amended Federal income tax returns, or by first applying this Directive for the company's current taxable year. In either case, the insurance company must attach a statement to its Federal income tax return for the Adjustment Year (either an amended return or the current taxable year return) stating that it is implementing the provisions of this Directive beginning in that Adjustment Year. See paragraph A.1. for the time period in which an insurance company may choose to implement this Directive. For a consolidated Federal income tax return, a separate statement should be attached for each insurance company.

C. Consistency Requirement

For this Directive to apply, an insurance company must use the SSAP 43R credit-related

impairment charge-off amount for all eligible securities that are partially worthless.

D. Certification Statement

Upon examination, if an insurance company has used its SSAP 43R credit-related impairment charge-offs of eligible securities reported on its Annual Statement as the amount of a partial worthlessness deduction under §166(a)(2), it must sign and complete the attached [LB&I Directive on Section 166 Partial Worthlessness Deduction Certification Statement](#) ("Certification Statement"). An insurance company must complete all sections of the Certification Statement, have the statement signed by an authorized individual, and provide the statement to the LB&I examiner within 30 days of a request for the statement. A separate Certification Statement may be requested for each taxable year under audit. For a consolidated Federal income tax return, a separate Certification Statement may be requested for each insurance company. An LB&I examiner will consider any insurance company not in compliance with these requirements ineligible for this Directive and subject to regular audit procedures.

The Certification Statement must be signed by an individual who is authorized to execute the insurance company's Federal income tax return for the taxable year under audit, and 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. Insurance companies should retain the underlying accounting documentation that would permit the LB&I examiner to reconcile the companies' Annual Statement with their partial worthlessness deductions for eligible securities reported on the Federal income tax return. If an insurance company fails to properly and timely submit the requested documentation that would permit the examiner to reconcile the company's statutory accounting impairment with its Federal income tax deductions for eligible securities, then the Industry Director or his/her delegate may determine that this Directive does not apply to the insurance company.

E. Contact

If you have any questions, please contact Elizabeth J. Kovash, PFTG Executive Assistant, Technical, at 505-837-5511 or Earnest Griffin, Senior Manager, Insurance & Financial Instruments IPGs at 713-209-4309. You may also contact the following IPGs:

RICs, REITs, REMICs & Banking
Life Insurance
Non-Life Insurance