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## Bringing Certainty to an Uncertain Tax Position: IRS LB&I Directive Addresses Partial Worthlessness Deductions Claimed by Insurance Companies

On July 30, 2012, the IRS Large Business & International (LB&I) Division issued guidelines intended to reduce the controversy associated with partial worthlessness deductions claimed by insurance companies. In brief, the guidelines, which were released as an industry director directive (the Directive), instruct IRS examiners not to challenge partial worthlessness deductions claimed by an insurance company under § 166(a)(2) if (i) they are limited to the credit-related portion of the impairment charge-off (not the full fair market value) and (ii) they comport with the National Association of Insurance Commissioners (NAIC) Statement of Statutory Accounting Principle (SSAP) 43R accounting rules. Importantly, although the Directive does not discuss whether the conclusive presumption of worthlessness standard of Treas. Reg. § 1.166-2(d) applies to insurance companies, the Directive, in effect, applies that standard to the credit-related impairment portion of the charge-offs.

### Background

With respect to a debt that does not constitute a security (as defined in § 165(g)(2)(C)), the rules concerning the determination of worthlessness are set forth in § 166. In general, § 166(a)(2) provides that the IRS may allow a deduction with respect to a debt in an amount that is not in excess of the part of the debt that is charged off within the taxable year “when satisfied that a debt is recoverable only in part.” Stated differently, § 166(a)(2) generally provides that partial worthlessness deductions may be allowed to be claimed with respect to a non-security debt.

As a general matter, insurance companies are required by state law to file annual statements using the accounting principles set out in the NAIC Accounting Practices and Procedures Manual (NAIC Accounting Manual). SSAP 43R, which is found in the NAIC Accounting Manual, provides the statutory accounting rules that must be followed when loan-backed and other structured securities are impaired and subject to charge-off. SSAP 43R became effective on September 30, 2009, and applies for all reporting periods ending on or after September 30, 2009.

Many insurance companies reported large partial worthlessness deductions under § 166(a)(2) on account of investment losses suffered during the credit crisis of 2008 and 2009 and the corresponding impairment charge-offs required for statutory accounting purposes by SSAP 43R. More recently, these partial worthlessness deductions ripened into proposed adjustments from IRS examiners, as attempts to verify compliance with bad debt deduction requirements strained resources on both sides of the issue. Up to now, the IRS and insurance companies have not had much success in resolving the amounts of the worthlessness deductions, largely because they have been pursuing different avenues for substantiation of the deductions. For the most part, the IRS has examined the details of substantiation under general standards for worthlessness, whereas insurance companies principally have relied on the conclusive presumption set forth in Treas. Reg. § 1.166-2(d) for regulated industries in support of the conclusion that

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\* Unless otherwise specified, all “section” and “§” references are to the Internal Revenue Code of 1986, as amended (the Code), and all “Treas. Reg. §” references are to the Treasury regulations promulgated thereunder, all as in effect as of the date of this document.

the worthlessness standard has been met. For this reason and others, the insurance industry and the IRS agreed to try to resolve the problem through the IRS's Industry Issue Resolution program.

## The Directive

The Directive generally provides that LB&I examiners should not challenge a partial worthlessness deduction claimed by an insurance company under § 166(a)(2) for the amount of the SSAP 43R credit-related impairment charge-offs of eligible securities as reported on its annual statement. If an insurance company claims a partial worthlessness deduction for eligible securities, but does not meet the requirements of the Directive, regular audit procedures will apply. For the 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.

For purposes of the Directive, the following definitions apply:

- “Annual statement” means the annual statement approved by the NAIC that an insurance company is required to file with insurance regulatory authorities of a state.
- “Eligible securities” means investments in loan-backed and structured securities within the scope of SSAP 43R, subject to § 166, and not subject to § 165(g)(2)(C), including real estate mortgage investment conduit (REMIC) regular interests.
- “Insurance company” means a life insurance company (as defined in § 816(a)) or a non-life insurance company (as defined in § 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.

**Sutherland Observation:** In light of these definitions, it does not appear that partial worthlessness deductions claimed by section 953(d) companies are covered by the Directive.

For the first taxable year in which an insurance company applies the provisions of the 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 for eligible securities will be 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 must make an adjustment to account for the difference between (i) the tax basis of the eligible securities and (ii) the statutory carrying value of the same securities (as increased by any non-credit-related portion of any charge-off not allowed as deductible under the Directive). For taxable years beginning after the Adjustment Year, the insurance company's partial worthlessness deduction for eligible securities will be the same amount as the company's SSAP 43R credit-related impairment charge-offs for the same securities as reported on its annual statement. Assuming that an insurance company complies with these mechanisms for the determination of its partial worthlessness deductions, the Directive states that LB&I examiners should not challenge the company's partial worthlessness deductions for eligible securities as reported on its federal income tax returns for all open years ending before the Adjustment Year.

If an insurance company is under examination and wants to apply the provisions of the Directive, the company generally will have two options: (i) change the amount of the company's partial worthlessness deduction for eligible securities for the taxable year(s) under examination to be consistent with the Directive or (ii) file amended federal income tax returns. If an insurance company is not under examination, it may choose to implement the provisions of the Directive either by filing amended federal income tax returns or by applying the Directive to 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 the Directive beginning in that Adjustment Year (an Implementation Statement).

**Sutherland Observation:** In the case of a consolidated return, the Directive indicates that a separate Implementation Statement should be attached for each insurance company that is a member of the consolidated group filing that return.

Upon examination, if an insurance company has used its SSAP 43R credit-related impairment charge-offs as the amount of a partial worthlessness deduction, the company must complete a certification statement (a copy of which is accessible by clicking [here](#)) and provide that statement to the LB&I examiner within 30 days of a request for the statement. Per the Directive, an LB&I examiner will consider any insurance company not in compliance with this requirement ineligible for the Directive and subject to regular audit procedures.

**Sutherland Observation:** Insurance companies should retain the underlying accounting documentation that would permit the LB&I examiner to reconcile the companies' annual statements with any partial worthlessness deductions claimed.



*If you have any questions about this Legal Alert, please feel free to contact the attorneys listed below or the Sutherland attorney with whom you regularly work.*

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