U.S. TAX ASPECTS OF ASSET/ LIABILITY MATCHING FOR INSURANCE COMPANIES

By Aditi Banerjee, Brion D. Graber and Peter H. Winslow

At the March 2014 Investment Symposium, Dave Bell, Aditi Banerjee and Peter H. Winslow participated in a panel presentation (Session E2) titled "Tax Aspects of Asset/Liability Matching." The presentation discussed key tax issues that exist under current law with respect to asset rebalancing and hedging transactions that an insurance company might undertake. As a follow-up to that presentation, and in an effort to convey the information to a broader audience, this article summarizes the substance of that discussion for the readers of *Risks & Rewards*. Readers who would like to learn more about other tax issues of interest to individuals in the insurance industry can find informative articles in *Taxing Times*, the Taxation Section's newsletter.

SOURCES OF TAX CHARACTER AND TIMING MISMATCHES ON ASSET/LIABILITY BALANCING TRANSACTIONS

The fundamental tax quandary faced in insurance company asset/liability balancing transactions is a capital/ordinary mismatch in tax treatment. An insurance company's liabilities are reflected in tax reserves, which are ordinary in character for tax purposes (i.e., increases and decreases in tax reserves generate ordinary deductions and income, respectively). On the other hand, the assets used to satisfy these liabilities are capital in character for tax purposes. Moreover, income earned on capital assets is generally ordinary in nature while gain and loss on the underlying assets is capital in nature. This causes tax inefficiency, because capital losses on assets cannot generally be used to offset previous ordinary income earned on the assets.

This tax inefficiency is exacerbated in a credit loss environment. Credit losses are generally recognized for tax purposes only upon sale or maturity and are generally treated as capital losses. However, the income earned on the bond prior to sale or maturity would be ordinary in character. Moreover, a purchase of a distressed debt instrument at a discount often generates "market discount" income, which treats the discount in purchase price as ordinary interest income for tax purposes. In effect, a taxpayer is required to recognize ordinary interest income for tax purposes that it may never collect if the debt is of poor credit quality.

Limitations on Use of Capital Losses

Capital losses can only offset capital gains.[1] Any unused capital losses can only be carried back three years and carried forward for five years.[2] In a rising interest rate environment, a large amount of capital losses may be generated without offsetting capital gains within the relevant carryback/carryforward period. For statutory accounting purposes, loss carryforwards are reflected as deferred tax assets (DTAs) on the balance sheet. However, there are limitations on the ability to admit DTAs as capital. DTA admittance is limited by the amount of taxes paid by the company in the current year and the prior two years. Thus, at a time when substantial capital losses are generated, the company may be able to admit only a minimal amount of DTAs if it has been in a loss position in the past few years.

MANAGING TAX CAPACITY FOR CAPITAL LOSSES

This asymmetry between capital loss and ordinary income may be managed through two principal means, subject to accounting, business and regulatory constraints: (1) triggering embedded capital gains through sale/repurchase transactions or through special tax structuring transactions; and (2) obtaining an ordinary deduction through a partial worthlessness deduction.[3]

Options for Triggering Capital Gains on Appreciated Bonds

In order to utilize capital losses before they expire, a taxpayer may trigger embedded capital gains through a variety of mechanisms. This can be achieved through a sale and repurchase of a bond, through a sale and a purchase of another bond, or through certain tax technology, including the use of identified mixed straddle transactions or through constructive sales, discussed in more detail below.

IF THE REGULATIONS ARE FINALIZED IN THEIR CURRENT FORM, INSURERS WILL NO LONGER BE ABLE TO USE IDENTIFIED MIXED STRADDLES TO TRIGGER CAPITAL GAIN RECOGNITION WITHOUT DISPOSING OF ASSETS.

Sale and repurchase transactions are constrained by regulatory considerations. Regulatory requirements for asset and liability matching narrow the universe of investments that may be included in a portfolio. In addition, if appropriate substitute bonds are not found, cash flow testing reserves may be increased by regulators. The accounting treatment may also be unfavorable. Generally, if a bond is sold at a gain because yields have declined, repurchase of a lower-yield bond would trade future yield for a one-time gain. For Generally Accepted Accounting Principle (GAAP) purposes, the one-time gain reduces future investment income throughout the duration of the investment.

As an alternative to actual sales to recognize capital gains, life insurance companies have entered into identified mixed straddles that result in deemed asset sales for tax purposes. An identified mixed straddle is the holding of offsetting positions with respect to actively traded property that includes an I.R.C. § 1256 contract (which is any regulated futures contract, foreign currency contract, nonequity option, dealer equity option, or securities future contract) and a non- I.R.C. § 1256 contract (i.e., anything other than an I.R.C. § 1256 contract) that is specifically identified.[4] Historically, the unrealized gain or loss on a position in an identified mixed straddle is required to be recognized on the day prior to establishing the identified mixed straddle. As a result, by selecting bonds with unrealized gain to be part of an identified mixed straddle, capital gains can be realized without disposing of the bonds.

On July 18, 2014, however, final regulations were published that fundamentally changed this beneficial result.[5] Under those regulations, unrealized gain or loss on a position held prior to establishing an identified mixed straddle with respect to that position is taken into account at the time, and has the character, provided by the provisions of the Code that would apply if the identified mixed straddle were not established. The regulations apply to identified mixed straddles established after Aug. 18, 2014, with the result that insurers cannot use identified mixed straddles after that date to trigger capital gain recognition without disposing of assets.[6]

Taxpayers can use also "constructive sales" to trigger an embedded capital gain without actually having to sell an asset. Under I.R.C. § 1259, constructive sale treatment applies when taxpayers enter into short sales against the box[7] or other hedges that transfer substantially all of an appreciated asset's risk and return. In such a transaction, for tax purposes, capital gain will be recognized but not loss. Specifically, the asset will be treated as being sold at fair market value and then immediately repurchased, which results in a basis step-up and a restart of the holding period. These rules apply to stock, debt, partnership interests and actively traded trust interests.

Opportunity for Ordinary Deduction—Partial Worthlessness Deduction

Under the tax rules, a "partially worthless business debt" is deductible as an ordinary expense to the extent that the taxpayer can establish that the part claimed to be worthless cannot be recovered.[8] Corporations subject to supervision by federal or state authorities may rely on the conclusive presumption of partial worthlessness that they charge off as required by the regulatory authority's specific orders.[9] In 2012, the IRS issued a directive instructing its examiners not to challenge certain partial worthlessness deductions claimed by insurance companies for credit-related charge-offs reported on their Annual Statements.[10]

The IRS noted that when certain securities held by an insurance company are impaired and subject to a charge-off, the company must observe certain accounting principles under NAIC SSAP 43R. Under these rules, pursuant to a charge-off, there is a reduction in the carrying value of a debt, resulting in a realized loss that is recorded on the company's Annual Statement. The asset's cost basis is required to be written down if the loss of principal is "other than temporary."

CONTINUED ON **PAGE 40**

In order to avail of the IRS' safe harbor, the company's deduction must be the same amount as the company's SSAP 43R credit-related impairment charge-off for the same securities as reported on its Annual Statement, with a positive or negative adjustment in the first year to account for differences between the security's tax basis and its statutory carrying value. Eligible securities for the purpose of this safe harbor are investments in loan-backed and structured securities that are within SSAP 43R's scope and that are not "securities" as defined for tax purposes. Notably, REMIC[11] regular interests constitute eligible securities for this purpose.

ADDITIONAL SOURCES OF CHARACTER AND TIMING MISMATCHES

Hedging Transactions:
Hedging transactions also have significant tax consequences for insurance companies. Tax hedge accounting must clearly reflect income through matching of the timing of income, deductions, gains and losses, in the hedging transaction and the item(s) hedged.[12] In general, for hedges of ordinary liabilities, any hedge gain/loss is matched to tax reserves. Gains/losses have ordinary character.[13] Tax hedge qualification also can be important because, as discussed below, tax hedges are excepted from the straddle and mark-to-market (MTM) rules.[14]

To qualify for tax hedge treatment, a hedging transaction must be clearly identified as such on the taxpayer's books and records on the day it is acquired, originated, or entered into (identification for financial accounting or regulatory purposes is insufficient).[15] In addition, the hedging transaction must (1) manage risk of price changes or currency fluctuations with respect to ordinary property or (2) manage risk of interest rate, price changes or currency fluctuations with respect to ordinary obligations (policy liabilities).[16] Significantly, a transaction that hedges a risk relating only to a capital asset (such as an insurance company's investment assets) does not qualify for tax hedge treatment.

GAAP and statutory accounting have different standards for hedging transactions than tax. For example, GAAP and statutory accounting require that the hedging relationship be highly effective at the inception of the hedge and on an ongoing basis. Tax accounting does not specify a degree of hedge effectiveness, but requires that the hedge manage specified risks. Due to these differences, situations may arise where a company can use hedge accounting for tax, but not for GAAP or statutory accounting, and vice versa.

Duration gap hedges by insurers that relate to both capital assets and ordinary liabilities are particularly problematic under current law because of uncertainty as to whether they qualify as tax hedges. It is the IRS' position that tax hedge qualification applies to a gap hedge only if the hedge is more closely related to ordinary liabilities than to capital assets.[17] Applying this standard is difficult because, by definition, a gap hedge relates to both assets and liabilities and closes the duration gap between the two. As a result, there is widespread inconsistency between insurers' and IRS auditors' application of current law.

House Ways and Means Committee Chairman Dave Camp (R-MI) released a comprehensive tax reform discussion draft on Feb. 26, 2014, that includes a proposal that would modify the definition of a qualified tax hedge to allow a hedge of a bond or other evidence of indebtedness held by an insurance company to qualify (despite the fact that such assets are otherwise treated as capital assets).[18] Adoption of this proposal would allow tax hedge accounting for virtually all insurance company hedges, including gap hedges. Although this hedging proposal would be beneficial, the discussion draft stops short of solving all the problems with insurer hedges because it would preserve the character mismatch between the ordinary derivatives and the hedged capital assets. In addition, tax reform does not appear imminent and it is unclear what changes might ultimately be included in tax reform.

IT IS THE IRS' POSITION THAT TAX HEDGE QUALIFICATION APPLIES TO A GAP HEDGE ONLY IF THE HEDGE IS MORE CLOSELY RELATED TO ORDINARY LIABILITIES THAN TO CAPITAL ASSETS.

Straddle Rules:
Straddles are offsetting positions that substantially reduce the risk of loss on interests in personal property of a type that are generally actively traded.[19] The straddle rules do not apply to tax hedges or straddles consisting solely of qualified covered call options and the optioned stock.[20] The rules constitute an anti-abuse regime intended to prevent deferral of income and conversion of ordinary income and short-term capital gain into long-term capital gain. Although the rules were not intended to apply to insurance company business hedges, they can nevertheless apply to those transactions.

Under the general straddle rules, loss deductions are deferred to the extent of unrecognized gains in any offsetting position.[21] Particularly for macro hedges, these rules could result in a loss being postponed for years. Recognized gains are not deferred. If the loss relates to a position in an identified straddle (i.e., any straddle that is clearly identified as such on the taxpayer's books and records before the close of the day on which the straddle is acquired), special rules apply. Under those rules, the loss is permanently disallowed and the basis of each of the identified positions offsetting the loss position in the identified straddle is increased by a specified percentage of the loss.[22]

Mark-to-Market Requirements:
In certain circumstances, the Code requires that an asset be MTM and deems a sale of the asset to occur. For example, the Code provides that each I.R.C. § 1256 contract held by a taxpayer at the end of the tax year be treated as though it were sold for its fair market value on the last business day of the year, with any resulting gain or loss taken into account.[23] Sixty percent of any gain or loss is treated as long term, and the remaining 40 percent is treated as short term.[24] When the taxpayer ultimately disposes of the I.R.C. § 1256 contract, any gain or loss previously included in income as the result of marking to market must be taken into account in determining the gain or loss of the actual disposition of the asset.[25] The MTM rules do not apply to transactions that qualify as tax hedges.[26] Interest rate swaps are not subject to the MTM rules.[27]

CONCLUSION

Navigating the tax pitfalls in asset/liability balancing is not an easy task. Asset character and timing mismatches can, and frequently do, occur. Without coordination between the investment, hedging, and tax personnel, capital losses can expire unused, potential DTAs can be lost, recognition of hedge losses can be postponed indefinitely, and expensive conflicts with IRS auditors could result.

ENDNOTES

1 I.R.C. § 1211(a). Unless otherwise indicated, all I.R.C. § references are to the Internal Revenue Code of 1986, as amended (the "Code").

2 I.R.C. § 1212(a)(1).

3 For many insurance companies, this issue has recently been of particular importance. As a result of the upheaval in the financial markets in 2008, many companies incurred significant capital losses in that year that could be carried forward only as far as 2013.

4 Temp. Treas. Reg. §§ 1.1092(b)-3T(a), -5T(e).

5 T.D. 9678. With the exception of the effective date, the final regulations adopt the position of temporary and proposed regulations that were published on Aug. 2, 2013. T.D. 9627; REG-112815-12.

6 The temporary and proposed regulations were initially released with an immediate effective date so that they would have applied to all identified mixed straddles established after Aug. 1, 2013. In response to concerns raised by the insurance industry, the government subsequently provided that the regulations would be effective no earlier than when finalized. Announcement 2013-44, 2013-47 I.R.B. 545. The final regulations indlude an effective date that is 31 days after the regulations were finalized.

7 A short sale against the box occurs when the taxpayer shorts a stock that it owns.

8 I.R.C. § 166(a)(2).

9 Treas. Reg. § 1.166-1(d)(1).

10 I.R.C. § 166: LB&I Directive Related to Partial Worthlessness Deduction for Eligible Securities Reported by Insurance Companies, LB&I-4-0712-009 (July 30, 2012).

CONTINUED ON PAGE 42

11 A REMIC, or real estate mortgage investment conduit, is an entity that files an election, owns primarily qualified mortgages and other permitted investments, issues multiple classes of investor interests that meet certain requirements, and satisfies certain other requirements. I.R.C. § 860D. A regular interest is an interest in a REMIC with fixed terms that is issued on the day the REMIC issues all of its interests and that is designated as such. In addition, a regular interest generally must unconditionally entitle the holder to receive a specified principal amount and provide that any interest payments made at or before maturity will be based on a fixed rate of interest or a variable rate (to the extent provided in regulations) or consist of a specified portion of the interest payments on qualified mortgages that does not vary. I.R.C. § 860G(a)(1).12. Treas. Reg. § 1.446-4.

13 I.R.C. § 1221(a)(7); Treas. Reg. § 1.1221-2(a)(1).

14 I.R.C. §§ 1092(e), 1256(e).

15 I.R.C. § 1221(a)(7); Treas. Reg. § 1.1221-2(f).

16 I.R.C. § 1221(b)(2)(A)(i); Treas. Reg. § 1.446-4.

17 T.D. 8555 (preamble), 1994-2 C.B. 180.

18 Tax Reform Act of 2014, § 3402(a)(1). This hedging proposal was included in the discussion draft in response to concerns raised by the insurance industry with an earlier Camp proposal generally requiring derivatives to be marked-to-market, with the only exception being for qualified tax hedges. That mark-to-market proposal is included in the comprehensive tax reform discussion draft, although insurers would now qualify for the exception.

19 I.R.C. § 1092(c)(1), (2).

20 I.R.C. § 1092(c)(4), (e).

21 I.R.C. § 1092(a)(1).

22 Id.

23 I.R.C. § 1256(a)(1).

24 I.R.C. § 1256(a)(3).

25 I.R.C. § 1256(a)(2).

26 I.R.C. § 1256(e)(1).

27 I.R.C. § 1256(b)(2)(B).

Aditi Banerjee is a lawyer in the Tax Department at Prudential, specializing in US tax matters and M&A. Prior to joining Prudential, she was a tax attorney for seven years at Sullivan & Cromwell, advising on cross-border transactions, international tax issues, tax controversy matters, financial restructuring, structured finance transactions, private equity transactions, partnership tax issues and M&A transactions. She is a graduate of Yale Law School (J.D.) and Tufts University (B.A., International Relations)..

Brion D. Graber is a partner with the Washington, D.C. law firm of Scribner, Hall & Thompson, LLP and may be reached at bgraber@scribnerhall.com.

Peter Winslow's practice includes audit, administrative appeals and litigation on tax issues that affect insurance companies. His tax planning work broadly covers most federal tax issues involving insurance companies, including insurance reserves, investments, reinsurance, valuation, accounting and insolvency. He is engaged as an expert witness on insurance tax matters in litigation and in proceedings involving insurance company tax issues, and is a frequent speaker and writer on insurance tax issues. Peter represented the insurance industry on the IRS Information Reporting Program Advisory Committee and is a former member of the editorial board of the Society of Actuaries Taxing Times publication. He can be reached at pwinslow@scribnerhall.com.