Internal Revenue Service

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Legend

Parent:
EIN:

Taxpayer 1:
EIN:

Taxpayer 2:
EIN:

Year A:

Year B:

Date A:

Date B:

Date C:

Date D:

Date E:

Date F:

Date G:

Date H:

Date I:

Date J:

Date K:

Date L:

Date M:

IC:

Broker A:

Amount 1:

Amount 2:

Amount 3:

Amount 4:

Amount 5:

Amount 6:

Amount 7:

Amount 8:

Amount 9:

Amount 10:

Amount 11:

Amount 12:

Amount 13:

Amount 14:

Amount 15:

Amount 16:

Amount 17:

Number A:

Number B:

Number C:

Subaccount A:

Investment A:

Company A:

Feature A:

Court A:

Dear :

This is in response to your ruling request dated July 24, 2008 requesting certain rulings concerning the federal income tax consequences regarding the recognition of a loss on the surrender of bank owned life insurance (BOLI) policies submitted by Parent on behalf of itself and its subsidiaries, Taxpayer 1 and Taxpayer 2. Supplemental submissions were provided on October 23, 2008, February 10, 2009, March 18, 2009, April 15, 2009, June 3, 2009, June 4, 2009 and June 19, 2009.

FACTS:

In Year A, Parent made a business decision to purchase additional BOLI policies to offset projected costs of future employee benefits. Taxpayer 1 and Taxpayer 2 each purchased adjustable group life insurance policies from IC through Broker A. Taxpayer 1 purchased one BOLI policy on Date A for a premium payment of Amount 1 and its second BOLI policy on Date B for Amount 2. Taxpayer 2 purchased one BOLI policy on Date A for Amount 3 and its second policy on Date B for Amount 4. On Date C, Taxpayer 1 and Taxpayer 2 each made a subsequent payment of Amount 5 and Amount 6, respectively, to increase the amount of insurance coverage on the lives insured under the BOLI policies purchased on Date A and Date B. The BOLI policies

are variable life insurance contracts that are designed to meet the requirements of sections 7702 and 817 of the Internal Revenue Code.

The terms of the BOLI policies provide that Taxpayer 1 and Taxpayer 2 are allowed to allocate the value of the policy among several investment options. Both Taxpayer 1 and Taxpayer 2 directed premiums to Subaccount A. This subaccount had two features that differentiated it from the other investment options. First, Subaccount A was invested in shares of Investment A. The private placement memorandum for Investment A indicated that it invested in bank-eligible investments, which utilized leverage and short selling to generate higher than expected returns than would typically be generated by directly holding bank eligible investments. Second, Subaccount A had Feature A, which protects a portion of the cash surrender value that Taxpayers would realize upon the full surrender of the BOLI policies. This Feature A was provided by Company A to IC.

Feature A has been modified three times since Taxpayer 1 and Taxpayer 2 purchased the BOLI policies. These modifications (wrap agreements) were aimed at increasing the amount of the surrender value protection provided by Feature A. These modifications were effected through IC's creation of new investment options within the BOLI policies. Taxpayer 1 and Taxpayer 2 reallocated its investments of the policy value to the new investment option each time. Taxpayer 1's and Taxpayer 2's underlying investment before and after each reallocation continued to be in shares of Investment A.

Under the Feature A, IC is required to pay a fee to Company A generally equal to, on an annualized basis, less than Number A percent of the book value of the assets of the applicable subaccount under each of the BOLI policies. The term of each Feature A began on either, Date E or Date F, and generally continue until Year B.

Feature A requires Company A to pay IC amounts based upon a complex formula. In general, this formula requires a payment to the extent of the excess book value over the fair market value of the assets included in the subaccount of a separate account maintained by IC for the benefit of either Taxpayer 1 or Taxpayer 2, as the case may be. Both the book value and the fair market value are measured on the day immediately preceding the termination of Feature A or other termination date. Upon surrender of an IC policy, Taxpayer 1 or Taxpayer 2, as the case may be, generally is entitled to receive both the cash value of the chosen investment option and any amounts received by IC from Company A pursuant to Feature A. Notwithstanding the forgoing, it is possible that neither Taxpayer 1 nor Taxpayer 2 will receive any payment under Feature A.

From the original investment date, the shares in Investment A have not performed as expected. At the time of the original allocation of the policy value by both Taxpayer 1 and Taxpayer 2, the shares in Investment A were expected to significantly

out perform the benchmarks for various investment strategies. However, the market value of the Investment A shares began to deteriorate around Date D (around the same time as problems began to appear in the credit markets). Consequently, Taxpayer 1 and Taxpayer 2 exercised their option to reallocate Number B percent of their respective investment in Investment A shares to a money market investment option within the IC policies. This reallocation was completed in Date G.

The remaining Investment A shares have continued to lose market value since this reallocation. These shares have lost over Number C percent of their initial value through Date H. The entity that issued the Investment A shares has liquidated some of the shares. Taxpayer 1 and Taxpayer 2 have allocated the liquidation proceeds that they have receive to other investment options within the IC policies. They have been allocated to a money market investment option.

On Date I, Taxpayer 1 and Taxpayer 2 filed suit in Court A against IC and Broker A regarding their investment in the BOLI policies claiming that IC and Broker A failed to closely monitor and manage the investment. Because Taxpayer 1 and Taxpayer 2 have taken a significant write down in the value of the BOLI products, they claim that they have suffered substantial damages in an amount to be determined at trial.

Taxpayers represent the following through Date J: (1) the investment management fees which are charged against policy values are Amount 11, (2) the fee paid for Feature A which is charged against the investments is Amount 12, (3) the amounts received from IC are Amount 13, (4) the cash surrender value of the BOLI policies in Year A was Amount 14, (5) the cash surrender value on Date J is Amount 15 (6) that at the time it filed this ruling request through Date M, there was and is a reasonable prospect of recovery of the loss from the surrender of the BOLI policies with IC (7) that the amount of the recovery cannot be ascertained with reasonable certainty as of Date M, (8) that the taxpayers will not claim an income tax deduction for any

portion of any loss with respect to the surrender of the BOLI policies with IC for which there exists a claim for reimbursement with respect to which there is a reasonable prospect of recovery until the taxable year in which it can be ascertained with reasonable certainty whether or not such reimbursement will be received, and (9) that the scope of the claims against IC and Broker A is not limited to a portion of the loss.

Under the terms of the BOLI policies, IC deducts a monthly charge from the "policy value". The "policy value" generally is equal to the sum of the value of the BOLI policies' accumulation units in each subdivision of the separate investment account established by IC to review and invest net premiums allocated under such IC policy plus the amount in the fixed account plus the amount in the loan account less any mortality and expense risk charges which have accrued since the last monthly date. The "policy value" is determined on the date the respective IC policy is issued and on each valuation date thereafter. The "policy value" may be more or less than premiums paid. This deduction is from the "policy value" in each Subaccount (*i.e.*, each commingled investment portfolio made available by IC) is to compensate IC for both the mortality and expense risks assumed as the issuer of each of the IC policies. The mortality risk that IC assumed is that the insureds, as a group, will live for a shorter period of time than IC estimated when it issued each of the IC policies. The expense risk is that the monthly contract charge may be insufficient to cover the actual administration expenses of the IC policies.

Under the terms of each IC policy, each IC policy may qualify for a mortality experience credit when the mortality reserve is in excess of the maximum mortality reserve. The maximum mortality reserve is equal to one year's cost of insurance charges. Upon surrender of an IC policy, a final mortality experience credit will be determined and refunded. The amount of the final mortality experience credit will be the amount of the mortality reserve at the date of surrender. The final mortality experience refund will be considered a pre-payment of any death claims submitted or in the course of settlement as of the surrender date.

Since the inception of each of the BOLI policies, there have been only two mortality experience credits issued by IC. In Date K, a mortality experience credit of Amount 16 was issued with respect to the BOLI policies. In Date L, a mortality experience credit of Amount 17 was issued with respect to the BOLI policies.

RULINGS REQUESTED:

Taxpayer 1 and Taxpayer 2 plan to surrender their BOLI policies with IC and have requested the following rulings:

(1) That Taxpayer 1 and Taxpayer 2 are each allowed a deduction under section 165 relating to the surrender of the IC policies; provided however, that no portion of any such loss of which there exists a claim for reimbursement with respect to which there is

a reasonable prospect of recovery is sustained for purposes of section 165 until the taxable year in which it can be ascertained with reasonable certainty whether or not such reimbursement will be received.

(2) That the amount of the loss deduction for each of the IC policies shall be computed by subtracting the applicable tax basis of each policy from the surrender proceeds of each policy (which will include any amounts received as a result of both Feature A and any claim for reimbursement).

(3) That the tax basis of the policies shall equal the sum of the premium payments, plus the mortality credits, less the cost of insurance, less the mortality and expense deduction (net of mortality experience credits).

LAW AND ANALYSIS:

Section 72(e) governs the federal income tax treatment of amounts received under annuity, endowment, or life insurance contract that are not received as an annuity. In general under section 72(e)(2), a non-annuity amount is received on or after the annuity starting date is included in gross income. If a non-annuity amount is received before the annuity starting date, it is included in gross income to the extent allocable to income on the contract, but not to the extent allocable to investment in the contract (*i.e.*, it is taxed on an income –first basis).

Section 72(e)(5) provides an exception to the income-first rule in the case of – (1) certain contracts including, under section 72(e)(5)(C), life insurance contracts other than a “modified endowment contract” (as defined in section 7702A) and (2) any non-annuity amount received under a contract on its complete surrender, redemption, or maturity.

Section 1.72-11(d)(1) of the Income Tax Regulations provides that any amount received upon the surrender , redemption, or maturity of a contract to which section 72 applies, which is not received as an annuity under the rules of paragraph (b) of section 1.72-2, shall be included in the gross income of the recipient to the extent that it, when added to amounts previously received under the contract and which were excludible from gross income of the recipient under the law applicable at the time of receipt, exceeds the aggregate of premiums or other consideration paid. See section 72(e)(2)(B).

If a non-annuity is received under a life insurance contract other than a modified endowment contract before the annuity starting date, or is received under a life insurance contract on the complete surrender, redemption, or maturity of the contract, section 72(e)(5)(A) requires the amount be included in gross income but only to the extent it exceeds investment in the contract. For this purpose, section 72(e)(6) defines “investment in the contract” as of any date as the aggregate amount of premiums or

other consideration paid for the contract before that date, less the aggregate amount received under the contract before the date to the extent that amount was excludable from gross income under this subtitle or prior income tax law.

Section 165(a) provides that there shall be allowed as a deduction any loss sustained during the taxable year and not compensated by insurance or otherwise. Section 165(f) provides that losses from the sales or exchanges of capital assets shall be allowed only to the extent allowed in sections 1211 and 1212.

Section 1.165-1(b) states that to be allowable as a loss under section 165(a), a loss must be evidenced by a closed and completed transactions, fixed by identifiable events, and except as otherwise provided in section 165(h) and 1.165-11, relating to disaster losses, actually sustained during the taxable year.

Section 1.165-1(d)(2)(i) states that if a casualty or other event occurs which may result in a loss and, in the year of such casualty or event, there exists a claim for reimbursement with respect to which there is a reasonable prospect of recovery, no portion of the loss with respect to which reimbursement may be received is sustained, for purposes of section 165, until it can be ascertained with reasonable certainty whether or not such reimbursement will be received. Whether a reasonable prospect of recovery exist with respect to a claim for reimbursement of a loss is a question of fact to be determined upon an examination of all facts and circumstances. Whether or not such reimbursement will be received may be ascertained with reasonable certainty, for example, by a settlement of the claim, by an adjudication of the claim, or by an abandonment of the claim. When a taxpayer claims that the taxable year in which a loss is sustained is fixed by his abandonment of the claim for reimbursement, he must be able to produce objective evidence of his having abandoned the claim, such as the execution of a release.

Section 264(a)(1) provides that no deduction shall be allowed for premiums paid on any life insurance policy, or endowment or annuity contract, if the taxpayer is directly or indirectly is the beneficiary under the policy or contract.

Section 263 generally prohibits deductions for capital expenditures. Section 263(a)(1) provides that no deduction shall be allowed for any amounts paid out for new buildings or for permanent improvements or betterments made to increase the value of any property.

Section 1.263(a)-4(d)(1) provides that except as provided in paragraph (f) of this section (relating to the 12 month rule), a taxpayer must capitalize amounts paid to create an intangible described in this paragraph (d). Section 1.263(a)-4(d)(2) provides that a taxpayer must capitalize amounts paid to another party to create, originate, enter into, renew, or renegotiate with that party any of the following financial interests, whether or not the interest is regularly traded on an established market. Section

1.263(a)-4(d)(2)(D) provides that an endowment contract, annuity contract, or insurance contract that has or may have cash value is included as a financial interest.

Section 1001(a) provides that the gain from the sale or other disposition of property shall be the excess of the amount realized therefrom over the adjusted basis provided in section 1011 for determining gain, and the loss shall be the excess of the adjusted basis provided in such section for determining loss over the amount realized.

Under section 1011, the adjusted basis for determining gain or loss from the sale or other disposition of property, whenever acquired, is the basis (determined under section 1012 other applicable sections of this subchapter, and subchapter C (relating to corporate distributions and adjustments), K (relating to partners and partnerships), and P (relating to capital gains and losses)) as adjusted as provided in section 1016. Under section 1012, the basis of property is the cost of such property, except as otherwise provided in this subchapter and subchapter C (relating to corporate distributions and adjustments), K (relating to partners and partnerships), and P (relating to capital gains and losses). Under section 1016(a)(1), proper adjustment must be made for expenditures, receipts, losses, or other items properly chargeable to capital account.

Rev. Rul. 61-201, 1961-2 C.B. 46, holds that in determining the amount of loss sustained by the original purchaser upon the surrender of its single premium refund annuity contract for cash consideration, the basis of the contract is its cost, less the amounts previously received under the contract which were properly excluded from the gross income of the recipient under the law applicable at the time of receipt. The excess of basis, thus determined, over the amount received upon surrender of the contract constitutes an ordinary loss.

Rev. Rul. 2009-13, 2009-21 I.R.B. 1029, provides guidance on the amount and character of an individual's income recognized on the surrender or sale of the individual's life insurance contract.

Rev. Rul. 2009-14, 2009-21 I.R.B. 1031, provides guidance to investors who buy life insurance contracts.

Both the Code and the courts acknowledge that a life insurance contract, although a single asset, may have both investment characteristics and insurance characteristics. See e.g., section 7702 (defining life insurance contract for federal income tax purposes by reference, in part, to both the cash surrender value and death benefits under the contract). In Keystone Consolidated Publishing Co. v. Commissioner, 26 B.T.A. 1210, 1211 (1932), the court states that total premiums paid did not represent the cost of the policy. To so hold would be to disregard the element of insurance protection in the period prior to the sale, the benefit of which accrued to the taxpayer. In London Shoe Co. v. Commissioner, 80 F.2d 230, 231 (2d Cir. 1935), the court determined that a life insurance policy ordinarily combines investment with

insurance protection. In Century Wood Preserving Co. v. Commissioner, 69 F.2d 967, 968 (3d Cir. 1934), the court determined that the policies of insurance involved in this case have a double aspect. They provide the present protection of ordinary life insurance and also a means of investment. Thus, to measure a taxpayer's gain upon the surrender or sale of a life insurance contract, it is necessary to determine that portion of the premium paid for the contract that was not expended for the provision of insurance before the sale.

In Century Wood Preserving Co. , 69 F.2d 967 (3rd Cir. 1934), a corporate taxpayer paid $98,242 of premiums on life insurance contracts over a period of several years to insure the lives of its officers. The taxpayer then sold the contracts to the officers for their cash surrender value of $57,646, claiming a loss for the difference between the total premiums paid and the amount for which it sold the contracts. The court held that the taxpayer did not have a loss, because it did not have a basis equal to the full amount of the premiums paid:

> If the [taxpayer] is entitled to a deduction from gross income, it is because [it has] sustained a loss, the basis of determining which is the cost of the property. … The cost of an asset is the real question here. It is obvious that cost is not the total amount paid in as premiums, since continuing insurance protection is part of the consideration for the contract. The part of the premiums which represents annual insurance protection has been earned and used. 69 F.2d at 968.

In Forbes Lithograph Mfg. Co. v. White, 42 F. 2d 287 (D. Mass. 1930), a corporate taxpayer took out life insurance polices on four of its officers in 1917 and paid a total of $40,583.50 in premiums until the surrender of the policies in 1923 for 422,784.44. The taxpayer argued it was entitled to a loss deduction, calculated by taking the total premiums over the cash surrender value. The district court held in favor of taxpayer, citing Lucas v. Alexander, 279 U.S. 572 (1929), a case involving valuation of a life insurance policy where, in dicta, the court noted that there is an economic and presumably taxable gain when life insurance is surrendered or sold, calculated by taking the difference between the total premiums paid and the amount received on disposal. According to the district court in Forbes Lithograph, the rules on calculating gain are “equally applicable” where the case is a loss.

In London Shoe Co., 80 F.2d 230 (2d Cir. 1935), a situation in which a corporate taxpayer sought to deduct the difference between the cash surrender value of a policy on the life of an officer from gross income as a loss, the court held that the corporate taxpayer was not entitled to deduct the difference between the cash surrender value and the net cost of the policy from gross income as a loss. The basis under section 113(a) of the Act of 1928 for purposes of determining gain or loss from the sale or disposition of property acquired after February 28, 1913, is the cost of such property.

The court determined that that the cost of the proceeds which the taxpayer received upon the surrender of the policy seems to have been approximately the amount of excess premiums set apart from year to year as a reserve. The court stated that losses, if any would be represented by the amount by which the premiums so far as they are paid toward the reserve exceed the cash surrender value of the policy. The court further stated that no loss was established in this case for the reason that the cost was approximately reflected in the cash surrender value and the portion of the premiums not used to build up the reserves was paid to obtain the insurance protection which for many years was afforded.

Under section 72(e)(5)(A) and section 1.72-11(d)(1), the amount that is received on the complete surrender of a life insurance policy is included in gross income but only to the extent it exceeds the investment in the contract as of any date as defined in section 72(e)(6). It is clear that neither the section 72 nor the underlying regulations address the situation of whether there is a loss on the complete surrender of a life insurance policy and if there is a loss, what is the amount of the loss. Section 165(a) allows a deduction for any loss sustained during the taxable year that is not compensated for by insurance. For purposes of section 165(a), section 165(b) provides that the basis for determining the amount of the loss is the adjusted basis provided in section 1011 for determining the loss from the sale or disposition of property.

Section 264 prevents the current deduction of premiums otherwise allowable as a deduction under sections 162 and 212. Section 1.263(a)-4(d)(2) provides that a life insurance policy is a financial interest that must be capitalized. Accordingly, section 264 does not prevent the recognition of a loss when a life insurance policy is surrendered by a policyholder.

However, a loss is not sustained if the taxpayer has a claim for reimbursement with a reasonable prospect of recovery. Section 1.165-1(d)(2). See also Dawn v. Commissioner, 675 F.2d 1077 (9th Cir. 1982); Ramsay Scarlett and Company, Inc. v. Commissioner, 61 T.C. 795 (1974), *aff'd*, 521 F.2d 786 (4th Cir. 1975); Parmalee Transportation Co. v. United States, 173 Ct. Cl. 139, 351 F.2d 619 (1965); and Estate of Scofield v. Commissioner, 266 F.2d 154, 159 (6th Cir. 1959), revg. 25 T.C. 774 (1956).

CONCLUSIONS:

Taxpayer 1 and Taxpayer 2 are each allowed a deduction under section 165 relating to the surrender of the IC policies; provided however, that no portion of any such loss of which there exists a claim for reimbursement with respect to which there is a reasonable prospect of recovery is sustained for purposes of section 165 until the taxable year in which it can be ascertained with reasonable certainty whether or not such reimbursement will be received.

The amount of the loss deduction for each of the IC policies shall be computed by subtracting the applicable tax basis of each policy from the surrender proceeds of each policy (which will include any amounts received as a result of both Feature A and any claim for reimbursement).

In the present situation, we conclude that the tax basis of the policies under sections 1011 and 1012 and the authorities cited above shall equal the sum of the premium payments (Amount 8), plus the mortality credits, less the cost of insurance (Amount 9), less the mortality and expense deduction (net of mortality experience credits) (Amount 10). In determining the policy value at surrender, the investment management fee (Amount 11) is taken into account as a charge against investments and the fee for Feature A (Amount 12) is taken into account as a charge against the investment value of each Subaccount and reduce the amount that otherwise would be paid to each Taxpayer.

Except as set forth above, no opinion is expressed or implied concerning the tax consequences of any aspect of any transaction or item discussed or referenced in this letter. This ruling is directed only to the taxpayer requesting it. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

In accordance with the Power of Attorney on file with this office, a copy of this letter is being sent to your authorized representatives.

A copy of this letter must be attached to any income tax return to which it is relevant. Taxpayers filing their returns electronically may satisfy this requirement by attaching a statement to their return that provides the date and control number of the letter ruling.

The ruling contained in this letter is based upon information and representations submitted by the taxpayer and accompanied by a penalty of perjury statement executed by an appropriate party. While this office has not verified any of the material submitted in support of the request for this ruling, it is subject to verification on examination.

Sincerely,

/S/

SHERYL B. FLUM
Branch Chief, Branch 4
Office of the Associate Chief Counsel
Financial Institutions & Products