



# Primer: Introduction to Investments

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# Agenda

- Investments in general
- Debt Securities
- Equity Securities
- Other Invested Assets
- Other investment related items
- Hedging and Derivatives

# Investments in General

- Life insurers collect premiums from contract holders and invest the funds until benefit payments are due
- Funds are invested with the intent that the income from investments, plus proceeds from maturities, will meet the ongoing cash flow needs of the insurance entity
- An insurer's investment strategy is intended to complement the cash flow requirements of the insurance business, differs for different types of insurance companies and products
- Premium rates, contract benefit liabilities, and certain contract features (such as credited interest rates on interest sensitive products) are determined based on specific assumptions regarding the use of investable funds and rates of return earned on those funds
- Differences in the assumed yields on investable funds and actual yields have a significant effect on insurers' profits or losses
- Typical portfolio consists of debt securities, equity securities, mortgage and other loans, real estate investments, contract loans, and derivative instruments.

# Debt Securities

# Debt Securities – What are they

A bond is a debt security, similar to an I.O.U. When you purchase a bond, you are lending money to a government, municipality, corporation, federal agency or other entity known as an issuer. In return for that money, the issuer provides you with a bond in which it promises to pay a specified rate of interest during the life of the bond and to repay the face value of the bond (the principal) when it matures, or comes due.

- May be public issues or private placements
  - Purchased at a discount, a premium, or par value
  - Generate interest income to the holder
  - Sale may result in a realized gain or loss
- Corporate bonds – principal paid at maturity
  - Structured bonds – principal paid in multiple installments
  - Tax-exempt bonds – issued by a municipal or local government
  - Convertible debt instruments – provides the holder with the right to convert the principal amount into common stock
  - Collateralized mortgage obligations – issuer purchases or issues mortgages then contributes them to a trust
  - Bond mutual funds

# Debt Securities – §1276 Market Discount

## Discount Security

- A debt security purchased on the secondary market for an amount that is **LESS** than security's face or par value (the redemption price at maturity).
- Generally occurs where the debt instrument's stated interest rate is **LESS** than the market interest rate.
- For financial reporting purposes, discount is accreted into income over the term of the debt security so that at maturity the carrying value equals the redemption price.

## Bond discount accretion

- Increases statutory income as discount is accreted
- Increases basis of bond
- Reduces potential gain/increases potential loss on sale

## Computation of market discount

- Ratable accrual method – Code section 1276(b)(1), or the
- Constant interest method – Code section 1276(b)(2)

Market discount is generally not accreted into taxable income currently

- An election to include market discount currently can be made under Code section 1278(b).

The following are not market discount bonds and therefore are not eligible for deferral

- Short-term investments – Code section 1278(a)(1)(B)(i)
- U.S. savings bonds – Code section 1278(a)(1)(B)(ii)

# Debt Securities – Market Discount Example

## Facts:

- Life Co purchases a bond on 1/1/20X0 with face or par value of \$100 for \$80.
- The bond has a maturity of 12/31/20X4.
- For purposes of this example, assume discount is calculated as accruing ratably over the remaining 5 year term of the bond.
- Life Co has elected to defer the recognition of market discount.
- On 1/1/20X4, Life Co sells the bond for \$120.
- The cumulative deferred market discount is \$16.

Question: How much and what is the character of Life Co's gain or loss on the sale?

## Solution:

- Life Co has a \$40 total gain [ $\$120$  sale proceeds –  $\$80$  cost]
- The portion of gain treated as ordinary income under section 1276 is the lesser of the previously deferred market discount or the gain. The gain is \$40 and the previously deferred market discount is \$16. Therefore, \$16 of the gain is treated as ordinary income.
- Life Co will recognize \$16 of ordinary income and \$24 of capital gain.

# Debt Securities – §1272 Original Issue Discount

- A debt security that is issued on the primary market at less than par, but must be redeemed for full par value at maturity
- Original Issue Discount (OID) –generally requires the holder of debt instruments to include the OID in income over the term of the debt instrument
- OID is included as interest in gross income of a holder under a constant yield method: IRC Section 1272(a)(3) generally applicable to corporate bonds, treasury notes, term loans issued with OID, etc., and requires the accrual of OID on the basis of an economic YTM. OID rules are applied differently for structured bonds.
- Sometimes need to make some assumptions to enable the computation of the economic YTM for bonds with put and/or call options, alternative payment schedules, and floating rate converted to equivalent fixed rate instrument
- De minimis OID –If OID is less than 0.25% of the instrument’s Stated Redemption Price at Maturity (SRPM), multiplied by the number of full years to maturity, OID shall be considered \$-0- to the holder
- Constant Yield Method- Method of calculating accrued discount on bonds trading in the secondary market
- Generally calculated by multiplying the adjusted basis by the yield at issuance and then subtracting the coupon interest
  - Alternative method: ratable accrual method  
Constant Yield Method usually results in a smaller accrual of discount.
  - Constant Yield Method requires more complex calculations.
- If a taxpayer purchases a debt instrument having OID from another holder, the purchaser must include in income the daily portions of the OID from the purchase date, subject to certain adjustments.
- If the purchase price is lower than the adjusted issue price, the purchaser has market discount in addition to the full amount of remaining OID.
- If the purchase price is higher than the SRPM, the purchaser has no OID accruals and can amortize the excess of purchase price over the SRPM as premium.
- If the purchase price is higher than the adjusted issue price, but less than the SRPM, the purchaser has OID and acquisition premium.

# Debt Securities – Market Premium

## Premium Security

- A debt security purchased for an amount that is **GREATER** than security's face or par value (the redemption price at maturity).
- Generally occurs where the debt instrument's stated interest rate is **GREATER** than the market interest rate.
- For financial reporting purposes, premium is amortized into income over the term of the debt security so that at maturity the carrying value equals the redemption price.

## Bond premium amortization

- Decreases statutory income
- Decreases basis in bond
- Increases potential gain/decreases potential loss on sale

## Section 171(a)(1)

- Amortizable bond premium is allowed as a deduction

## Section 171(c)

- Taxpayer must make an election to amortize taxable bond premium.
- Election to amortize bond premium: Treas. Reg. Section 1.171-4

## Section 171(b)(3)

- Amount of amortization is calculated based on the yield to maturity for bonds issued after September 27, 1985.
- For bonds issued prior to September 28, 1985, premium is amortized on the method regularly employed by the taxpayer

## Section 171(e)

- Amortization is treated as a reduction of interest income rather than as a deduction.

# Debt Securities – Acquisition Premium

- Exists when an investor purchases a debt instrument on the secondary market having original issue discount (OID) and the purchase price is higher than the adjusted issue price (the issue price, plus the OID accrued by the previous owner)
- Constitutes an offset to OID for tax purposes
- The offset is accomplished by multiplying each OID inclusion by the following fraction: (Cost of the debt instrument over adjusted issue price (AIP)) divided by the remaining OID to be accrued (SRPM – AIP)
- Only applies to bonds issued with non-de minimis OID
- Mandatory – no election; de minimis rule with respect to acquisition premium
- Acquisition premium amortized using the fixed ratio method described in Section 1272(a)(7)
- Ratio computed at time of acquisition and generally not recomputed each period

# Debt Securities – Tax Exempt Bonds

- Interest income not taxable on federal return
- Market discount is not considered tax-exempt interest and is not deductible, or subject to proration
- OID is considered tax-exempt interest, subject to proration
- Market premium must be amortized, however amortized amount cannot be deducted from taxable income. Basis is adjusted.

# Bad Debt Deduction/Worthlessness

- Two main categories to consider for losses
  - Section 165(g), Worthless Securities
    - Any security which is a capital asset which becomes worthless during the taxable year.  
Security means:
      - Share of stock,
      - Right to receive a share of stock, or
      - A bond, debenture, or note issued by a corporation or government
    - Taxpayer has burden of proof on worthlessness and timing
    - Section 165(i), Disaster Losses. Election to take deduction in preceding year
  - Section 166, all other security types not covered by 165(g)
    - Companies and IRS treatment varied on these losses prior to directive
    - Different assumptions and independent determinations caused significant burden

# Debt Securities – §166 and Partial Bad Debts

- July 30, 2012: LB&I Directive Related to Partial Worthlessness Deduction for Eligible Securities Reported by Insurance Companies
- §166(a)(2) allows for an ordinary deduction on a capital asset for partial worthlessness
- Directive allows insurers who take the partial worthlessness deduction for SSAP 43R Credit related impairment charge-offs on the annual statement to not be challenged by examiners
- Eligible securities: investments in loan-backed and structured securities within the scope of SSAP 43R, including ordinary interests in REMICS
- Applies for all reporting periods after September 30, 2009
- Amount of deduction is equal to:
  - SSAP 43R credit related impairment charge-off reported on annual statement, but
  - In no event may the tax basis of eligible securities be less than the post-charge-off Statutory carrying value

# Debt Modifications

- A modification occurs when the issuer and holder agrees to change the terms
- Treasury Reg. 1.1001-3 defines modifications and addresses significant modifications
- Five specific tests defined by 1.1001-3(e)(2)-(6), changes in:
  - Yield
  - Payment Timing
  - Obligor
  - Nature of debt
  - Accounting or financial covenants
- If modification deemed significant, existing debt is deemed exchanged for new debt resulting in tax consequences such as immediate gain/loss recognition
- If not deemed significant, not deemed an exchange limiting tax consequences

# Debt Modifications – LIBOR Transition

- London Interbank Offered Rate is being replaced by the end of 2021
- Impacts new and existing loans, also derivatives
- Will change in reference rate result in a significant modification under Treasury Reg 1.1001-3(e)(2), Change in Yield?
  - General rule is yield change is significant if modification is greater than:
    - 0.25%, or
    - 5% of annual yield of the unmodified instrument
- IRS guidance to date, positive to date i.e., most instances not taxable
  - 10/9/2019, Proposed Regulations, Guidance on Transition from Interbank Offered Rates to Other Reference Rates – need to pass several tests including FMV
  - 10/9/2020, Rev Proc 2020-44 mitigates potential tax consequences of adopting fallback language recommended by the Alternative Reference Rates Committee

# Distressed Debt

- Loan by loan analysis
- No definition of distressed debt in code or regulations
- Items to consider
  - Stopping interest accruals if reasonably certain it will not be collected
  - Changes to Market Discount – might not apply if issuer is in bankruptcy when acquired, debt is in default, or if past maturity date
  - Changes to payment ordering rules
- Cost recovery method is when all payments allocated to basis recovery, assumes market discount does not apply and debt is non-performing on acquisition

# Capital Gain/Loss Planning

- Capital losses are handled differently for a Corporation compared to Individuals
  - Individuals have favorable rate
  - Individuals can deduct up to \$3,000 against income
  - Carryforward treatment indefinitely forward for individuals versus backward 3-years and forward 5-years
- Proper planning necessary to avoid expiration of capital losses
- Consider tax rate differentials
- Typically requires various disciplines, can impact many things including:
  - Book earnings
  - Capital and Surplus, SSAP 101
  - Cash flows
  - Portfolio concerns: duration and credit quality
  - Accounting and operational
  - Business purpose

# Equity Securities

# Equity Securities – What they are

- Represent units of ownership in a corporation or the right to acquire or dispose of an ownership interest in a corporation at fixed or determinable prices
- Generate cash dividends or dividends paid in the form of additional shares of stock
- Sale of shares of equity securities usually results in a realized gain or loss
- Common stock
- Nonredeemable preferred stock
- Mutual fund shares
- Warrants
- Equity options

# Equity Securities – Carrying Value

- Generally for both GAAP and STAT reporting purposes, equity securities are carried at fair value. That fair value increase for book purposes is taken either through equity or through the income statement

# Equity Securities – Impairments

- §165(a): Any loss sustained during the taxable year shall be allowed as a deduction
- Must establish the security and worthlessness
  - Had a basis
  - Was not worthless before the year taxpayer claimed the worthlessness
  - Was worthless in the year claimed
  - Balance sheet insolvency
  - Lack of future potential value
  - Reasonable person would regard collection as hopeless

# Equity Securities – Accrued Dividend Income

- Dividends are taxable when received – Rev. Rul. 78-117
- Tax adjustment to reverse out book change in accrued dividends.

- Example:

Statutory journal entry:

DR. Accrued dividends received \$100K

CR. Investment income \$100K

To compute taxable income, take a \$100K favorable adjustment to remove book income

# Equity Securities – Dividends Received Deduction

- Section 243: corporate dividends received deduction
  - 50 percent DRD - anything other than below
  - 65 percent DRD – from a 20% owned corporation
  - 100 percent DRD – from small business investment company
  - 100 percent DRD – qualifying dividend from member of the same affiliated group
- Stock on which dividend was paid must be held by the taxpayer for 45 days or less during the 91-day period beginning on the date that is 45 days before the ex-dividend date.
- Dividends from exempt entities not subject to federal income tax (including foreign corporations) are not eligible for the DRD
- Aggregate DRD is generally limited by taxable income (i.e., 50% DRD may not exceed 50% of taxable income). Special rules determine taxable income to exclude deductions for net operating losses (NOLs) and capital loss carrybacks

# Other Invested Assets

# Other Invested Assets

- Schedule BA – Other invested assets contains unique assets that don't necessarily fit into the bond or stock classification
  - Surplus notes
  - Collateral loans
  - Fixed or variable rate investments
  - Joint ventures, partnerships or LLCs
  - Some types of Mutual Funds
  - Real property

# Mutual Funds

- Taxpayer needs to determine whether interest or dividends are received from mutual funds
  - Impact on DRD
  - Potentially considered interest income

# Partnerships

- Statutory accounting depends on whether the insurance company owns a minority interest (less than 10%) or lacks control of the invested entity
- §701 and §702: a partnership is considered a “pass-through” entity so taxable income is reported as schedule K-1s are reported.
- Distributions made from a partnership to a partner generally do not constitute taxable income to the partner to the extent the partner has sufficient tax basis in its partnership units.
- Limited liability companies are taxed as partnership for federal income tax purposes.
- A single member LLC can elect to be taxed as a corporation, and is treated as a disregarded entity for federal income tax purposes.

# Surplus Notes

- Bond-like instrument issued by an insurance company
- Issued primarily by mutual insurance companies
- Pay a coupon and have a finite maturity
- Most state insurance regulators have allowed insurance companies who issue these to classify the capital raised from them as surplus, because the note holders are the last in line to make a claim on the company's assets in a default scenario
- Generally treated as debt instruments for federal income tax purposes

# Other Invested Related Items

# International Filings for Investments

- Controlled foreign corporation (CFC)
  - Form 5471
- Foreign partnerships
  - Form 8865
- Foreign disregarded entities
  - Form 8858
- Passive foreign investment company
  - Form 8621
- Transfer of Property to a CFC
  - Form 926
- International Boycott Report
  - Form 5713

# Other: IMR/AVR

- Interest maintenance reserve (“IMR”)
  - Capitalization of interest related realized gains and losses realized on debt securities, net of applicable income taxes.
  - Capitalized capital gains and losses are amortized into investment income over the approximated remaining period to maturity of the assets sold.
  - The IMR is not subject to any maximum or minimum value.
  - The IMR balance cannot be less than zero at any valuation date.
  - No equivalent item for tax purposes.
- Asset valuation reserve (“AVR”)
  - Valuation allowance against stocks, bonds, mortgage loans, etc.
  - Other side of the entry is equity.
  - No equivalent item for tax purposes.

# Wash Sales

- §1091 – A wash sale occurs when a taxpayer sells stock or securities at a loss, and within 30 days before or after the sale the taxpayer buys (or enters a contract to buy) substantially identical stock or securities.
- Taxpayer not allowed to claim loss on sale or exchange, must defer.
- Disallowed loss is added to the basis of the replacement security.
- Holding period for the replacement stock includes the holding period of the stock sold

# Other: Proration

- P&C:
  - §832(b)(5)(B)(i)
  - 25% of tax exempt interest and DRD disallowed
- Life
  - §805(a)(4)(D)(iii)
  - 30% of tax exempt interest and DRD disallowed (70% company share)
  - Taken as a reduction to the tax reserve change

# Derivatives

- A security whose price is dependent upon, or derived from an underlying asset
- Value is determined by fluctuations in the underlying asset
- Documented by contract between parties
- Common underlying assets: stocks, bonds, commodities, currencies, interest rates, and market indexes
- Tax treatment of these is governed under §1221 – sometimes considered a tax hedge and other times not
- Ordinary/Capital treatment is subject to these rules

# Use of Derivatives

- Profitability of certain annuity products is significantly affected by market indexes and interest yields on investments
  - Part of interest rate earned to policyholder is a guaranteed minimum of premiums, and the other part linked to an index
  - Use of options or futures contracts are common to mitigate this risk
- Interest rate risk: As interest rates increase, the unrealized gain position of fixed maturity securities (bonds) will decrease
  - Interest rate swaps are used to mitigate this risk

# Definition of a Hedging Transaction

- Defined as any transaction that a taxpayer enters into
  - in the normal course of the taxpayer's trade or business
  - To manage risk of price changes or currency fluctuations with respect to ordinary property held or to be held by taxpayer
  - To manage risk of interest rate or price changes or currency fluctuations with respect to borrowings made or to be made, or ordinary obligations incurred or to be incurred, by the taxpayer; or
  - To manage such other risks as the Secretary may prescribe in regulations.
  - See IRC Sec. 1221(b)(2)(A) and Treas. Reg. Sec. 1-1221-2(b)

# Hedge Identification

- Taxpayer must clearly identify a hedging (or recycled) transaction before the close of the day on which the taxpayer acquired, originated, or entered into the transaction.
- Taxpayer must identify the hedged items or risk being within 35 days of entering the hedge transaction.
- Identification of hedged items must make clear the items being hedged:
  - Which debt issuance current or anticipated as well as amount of issue actually hedged
  - Type and class of inventory hedged and which purchases and sales
    - As an example, the raise in price of corn in June.

# Hedging Program Identification

- A hedging program must describe the type of risk being hedged, items giving rise to the risk being aggregated, and sufficient additional information to demonstrate that the program is designed to reduce aggregate risk of the type identified.
- If the program contains controls on speculation (for example, position limits), the description of the hedging program must also explain how the controls are established, communicated, and implemented.

# GAP Hedges

- A gap hedge is one involving the difference (i.e. the gap) between a taxpayer's liabilities and that same taxpayer's assets that are used to fund its liabilities.
- One example that might be pertinent here is an insurance company's policy liabilities to current and future policyholders.
  - A change in interest rates might be of concern.
- As discussed, the hedged items must be ordinary items, as such the identification process should address the liabilities rather than the assets funding the liabilities.
- This is still a question of fact and subject to scrutiny.

# 988 Transactions

- The term “section 988 transaction” means
  - The acquisition of a debt instrument or becoming the obligor under a debt instrument.
  - Accruing (or otherwise taking into account) any item of expense or gross income or receipts which is to be paid or received after the date on which so accrued.
  - Entering into or acquiring any forward contract, futures contract, option, or similar financial instrument.
- if the amount which the taxpayer is entitled to receive (or is required to pay) by reason of such transaction is denominated or determined by reference to one or more functional currencies.

# 988 Transactions - Treatment

- Gain or loss is computed separately and treated as ordinary income or loss.
- Taxpayer may elect under certain circumstances to treat the gain or loss attributable to a forward, futures or option which is a capital asset in the hands of the taxpayer and not part of a straddle as capital gain or loss.
  - Must be identified prior to close of the day the transaction is entered into by the taxpayer.

# 988 Hedging Transactions

- Any transaction entered into by a taxpayer primarily to
  - manage risk of currency fluctuations with respect to property which is held or to be held by the taxpayer, or
  - manage risk of currency fluctuations with respect to borrowings made or to be made, or obligations incurred or to be incurred, by the taxpayer or
  - otherwise identified by the Secretary
- All 988 transactions that are part of the same hedge are integrated as one transaction.
- The mark to market rules of Sections 475 and 1256 do not apply to a 988 hedging transaction.

# The next chapter: What else will you need to know

- Zero coupon bonds
- Real estate
- REMICs
- Contract loans

# Questions