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Date:
September 23, 2013

Legend

Taxpayer:
E.I.N.:

Parent:

Bank A:

Bank B:

Year 1:

Year 2:

Year 3:

Date 1:

Date 2:

Date 3:

Date 4:

Date 5:

Policy 1:

Policy 2:

Policy 3:

Fund:

Investment Company:

Number A:

Number B:

Number C:

Number D:

Number E:

Number F:

Number G:

Number H:

Number I:

Number J:

Number K:

Number L:

Number M:

Number N:

Number O:

Number P:

Number Q:

Dear :

This is in response to your ruling request dated March 22, 2013 and supplemental letters dated August 12, 2013 and September 3, 2013, requesting certain rulings concerning the federal income tax consequences regarding the recognition of a loss on the surrender of bank owned life insurance (BOLI) submitted by Taxpayer.

FACTS

Taxpayer is a national banking association and is wholly owned by Parent, a holding company and bank holding company. Taxpayer qualifies as a bank within the meaning of section 581 of the Internal Revenue Code.

Taxpayer maintains a BOLI Program in which it acquires life insurance policies from a variety of life insurance providers, on a group of its officer-level employees. The BOLI Policies are invested in the general accounts and separate accounts of the BOLI insurers. The separate accounts (including various sub-accounts) typically consist of multiple investment fund options only available to the BOLI policyholders. The BOLI Program is subject to certain guidelines and restrictions designed to ensure that the BOLI Policies meet the definition of a “life insurance contract” under section 7702(a), are not modified endowment contracts under section 7702A, and the separate accounts meet the diversification requirements of section 817(h).

As part of its BOLI Program, Taxpayer acquired these BOLI Policies via a BOLI Grantor Trust. This BOLI Grantor Trust was set up by Bank A, which Taxpayer had acquired. Taxpayer represents that it is treated as owning an undivided 100% interest in each of the BOLI’s Grantor Trust’s assets for federal tax purposes. In Year 1 and Year 2, certain policies were acquired by the BOLI Grantor Trust. Policy 1 was issued on Date 1 and Policy 2 was issued on Date 2 by the same life insurance company. Policy 3 was issued on Date 3 by another life insurance company.

Each of the BOLI Policies permitted Taxpayer to select the timing and amount of its premium payments and to allocate these premiums among sub-accounts established within the separate accounts. Regarding all three BOLI Policies, a significant portion of the premiums were directed to a sub-account that invested in Fund managed by Investment Company. The Fund’s primary investment strategy was focused on generating returns in the fixed income market, with a particular focus on mortgage backed securities.

A feature of the sub-account that invested in Fund was the provision of stable value protection against potential losses on the premiums invested in the sub-account and future anticipated earnings thereon. For each of the BOLI Policies and their Fund

sub-account, the respective insurance companies entered into a wrap contract with Bank B. Each of the separate sub-accounts paid a formula based fee to Bank B for this protection. Under the wrap contract, certain restrictions were placed on the investment activities of the separate accounts. The stable value protection of the wrap contract was designed to stabilize the value of the underlying securities of the wrapped portfolio portion of the separate account such that the value was less impacted by market fluctuations.

Unless terminated earlier than its thirty year maturity date, upon the maturity of the wrap contract, Bank B, as the wrap provider was obligated to make payment to the separate account equal to the difference between the “wrapped portfolio market value” and the “investment value” less any accrued and unpaid amounts owed by the relevant separate account owed to Bank B for the stable value coverage. If a wrap contract matured with an investment value in excess of such contract’s wrapped portfolio market value, the respective separate account was entitled to a payment from Bank B equal to such excess. Alternatively, if the wrapped contract matured with such contract’s wrapped portfolio market value in excess of the contract’s notional investment value, the respective insurance company could be required to make additional payments to Bank B to the extent of such excess. In the event that the BOLI Policies were surrendered prior to the maturity date of the respective wrap contract and certain conditions were satisfied, Bank B was required to pay to the separate account the excess of such contracts notional investment value over the wrapped portfolio market value at the time prescribed under the wrap contract.

Taxpayer and BOLI Grantor Trust entered into two Settlement Agreements for the wrap contracts that were effective on Date 4. One Settlement Agreement was for the Policies 1, and 2 wrap contract. The other Settlement Agreement was for the Policy 3 wrap contract. Under both Settlement Agreements, amounts were determined and paid that resulted in the agreed termination of the wrap contracts with respect to Policies 1, 2, and 3. The two Settlement Agreements released the respective parties from all claims. Thereafter, Policies 1, 2, and 3 were surrendered on or before Date 5. The amounts paid under the Settlement Agreements are included in the amounts received from the respective life insurance company.

Pursuant to the terms of each of the surrendered BOLI Policies, a surrendered BOLI Policy’s “account value” is generally equal to the policy’s variable account value, plus any policy amounts invested in the insurance company’s general account assets (e.g., the “guaranteed principal account” or “fixed account”) less all administrative charges and fees (e.g., asset based compensation charges, custody fees, investment fund charges and other subaccount expenses, wrap fees, etc), monthly cost of insurance charges, and monthly mortality and risk expense charges.

Under the terms of Policy 3, Policy 3 qualifies for a mortality experience credit when the policy’s mortality reserve exceeds the maximum mortality reserve. The maximum mortality reserve for Policy 3 is equal to one year’s cost of insurance charges.

Upon the surrender of Policy 3, a final mortality experience credit was determined and refunded equal to the amount of the mortality reserve on Policy 3's surrender date, and was considered a prepayment of all death claims submitted or that were in the course of settlement as of the surrender date.

Taxpayer has made the following representations:

1. Except for the amounts received by Taxpayer on the surrender of Policies 1 and 2 as described in the submission and in accordance with the Policies 1 and 2 Settlement Agreement, Taxpayer has no reasonable prospect of receiving any further recoveries or additional amounts in connection with Policies 1 and 2, the stable wrap contracts or any other arrangements relating to Policies 1 and 2.
2. Except for the amounts received by Taxpayer on the surrender of Policy 3 as described in the submission and in accordance with the Policy 3 Settlement Agreement, Taxpayer has no reasonable prospect of receiving any further recoveries or additional amounts in connection with Policy 3, the stable wrap contract or any other arrangements relating to Policy 3.
3. During the term of Policy 3, Taxpayer did not receive any notice from the life insurance company that any action taken or proposed to be taken by, or any premiums paid by, Taxpayer in connection with Policy 3 could cause Policy 3 to be treated as a modified endowment contract under section 7702A(a) and to Taxpayer's knowledge, it has not taken any actions or paid any amounts in connection with Policy 3 that would cause Policy 3 to be a modified endowment contract under section 7702A(a).
4. Taxpayer is not a party to any current or pending litigation, arbitration proceedings against the insurance companies that issued the policies, Bank B, or any other party with respect to the surrendered BOLI Policies or the subject wrap contracts.
5. Taxpayer has not initiated nor participated in any litigation or arbitration proceedings against the insurance companies that issued the policies, Bank B, or any other party with respect to the surrendered BOLI Policies or the subject wrap contracts.
6. At the time Taxpayer surrendered the three BOLI Policies, the cash value of the surrendered BOLI Policies constituted approximately Number A% of Taxpayer's aggregate cash value in all of its BOLI Policies.
7. With respect to Policy 1 and at the time of its surrender: (a) the sum of premium payments equaled $ Number B; (b) it was not entitled to any mortality experience credits; (c) the total cost of insurance equaled $ Number C; (d) the aggregate mortality and expense deductions (net of mortality experience credits) equaled $ Number D; and (e) the total amount received by Taxpayer for Policy 1 on the surrender of the policy and the termination of the stable wrap contract equaled $ Number E.
8. With respect to Policy 2 and at the time of its surrender: (a) the sum of premium payments equaled $ Number F; (b) it was not entitled to any

mortality experience credits; (c) the total cost of insurance equaled $ Number G; (d) the aggregate mortality and expense deductions (net of mortality experience credits) equaled $ Number H; and (e) the total amount received by Taxpayer for Policy 2 on the surrender of the policy and the termination of the stable wrap contract equaled $ Number I.

9. With respect to Policy 3 and at the time of its surrender: (a) the sum of premium payments equaled $ Number J; (b) the sum of the mortality experience credits equaled $ Number K; (c) the total cost of insurance equaled $ Number L; (d) the aggregate mortality and expense deductions (net of mortality experience credits) equaled $ Number M; and (e) the total amount received by Taxpayer for Policy 3 on the surrender of the policy and the termination of the stable wrap contract equaled $ Number N. The total cost of insurance $ Number L for Policy 3 represents the gross amount paid not reduced by $ Number K sum of the mortality experience credits under Policy 3.
10. Policies 1, 2, and 3 were surrendered on or before Date 5.

RULINGS REQUESTED

Taxpayer is requesting a ruling that it is allowed a loss under section 165 relating to the surrender of BOLI Policies 1, 2, and 3, with the amount of such loss for each surrendered BOLI Policy computed by subtracting the applicable tax basis of surrendered BOLI Policy from the surrendered proceeds received by Taxpayer on each surrendered BOLI Policy (including amounts received on the termination of the wrap contracts under the respective Settlement Agreements).

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 exists 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 financial interests enumerated in section 1.263(a)-(4)(d)(i)(A) through (F), whether or not the interest is regularly traded on an established market. Section 1.263(a)-4(d)(2)(i)(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 subchapters 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 subchapters C, K, and P. 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, 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 $22,784.44. 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, a situation in which a corporate taxpayer sought to deduct from gross income as a loss the difference between the cash surrender value of a policy on the life of an officer and the net cost of the policy. 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 policyholder's adjusted basis in a policy exceeds the amount realized on surrender of the policy.

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).

CONCLUSION:

Taxpayer is allowed a loss under section 165 relating to the to the surrender of BOLI Policies 1, 2, and 3, with the amount of such loss for each surrendered BOLI Policy computed by subtracting the applicable tax basis of surrendered BOLI Policy from the surrendered proceeds received by Taxpayer on each surrendered BOLI Policy (including amounts received on the termination of the respective wrap contracts under the respective Settlement Agreements). With respect to each surrendered BOLI Policy, Taxpayer's basis in such policy is equal to the sum of the premium payments and the mortality credits, less the cost of insurance and the mortality and expense deductions (net of mortality experience credits). Accordingly, Taxpayer is entitled to a loss deduction under section 165 for taxable Year 3 of (1) $ Number O for surrendered Policy 1; (2) $ Number P for surrendered Policy 2; and $ Number Q for surrendered Policy 3 based on the representations in paragraphs 1 through 9, respectively.

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. No rulings have been requested and no opinion is expressed concerning whether the Policies qualify as a life insurance contracts under section 7702 or are a modified endowment contracts under section 7702A or concerning the treatment under subchapter L of the Code. No opinion concerning the tax consequences of any transaction or item discussed or reference in this letter if a Policy is a modified endowment contract. 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,

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