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INTERNAL REVENUE SERVICE
NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR
Assistant District Counsel

FROM: LON B. SMITH
Acting Associate Chief Counsel
(Financial Institutions and Products)

SUBJECT:

This Field Service Advice responds to your memorandum on Date-a. Field Service Advice is not binding on Examination or Appeals and is not a final case determination. This document is not to be used or cited as precedent.

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LEGEND

Date-a =
Taxpayer =
Parent = .
Year-1 =
$a =

$b =
$c =

ISSUE

Whether a chronological tracing of an insurance company's gross receipts from sales of capital assets is a proper means of identifying qualifying sales transactions for purposes of the abnormal capital loss deduction under § 832(c)(5) when the insurance company's total receipts from sales or exchanges of capital assets during the taxable year are greater than the maximum amount of those sales which, under the statute, are considered made for the purpose of obtaining funds to pay abnormal insurance losses?

CONCLUSION

Section 832(c)(5) provides that an insurance company may treat capital assets as sold or exchanged to pay abnormal insurance losses only to the extent that the gross receipts from those sales are not greater than the excess of the sum of certain specified cash disbursements during the taxable year over the sum of certain specified cash receipts. Section 1.822-8(c)(6)(ii) of the Income Tax Regulations further provides that the insurance company must make an apportionment of the gross receipts and resulting loss if, as the result of a particular sale or exchange of a capital asset, the company's gross receipts from sales of capital assets during the taxable year are greater than the maximum amount provided in § 832(c)(5). In light of this apportionment rule, and the illustrative computation set forth in Example (2) of § 1.822-8(c)(6)(iii), a chronological tracing of gross receipts up to the maximum amount allowed by § 832(c)(5) is a proper means of identifying qualifying sales for purposes of the abnormal capital loss deduction.

FACTS

Taxpayer is a stock property and casualty insurance company which is taxable under § 831 of the Internal Revenue Code. Taxpayer joins with Parent and other affiliated corporations in filing a consolidated Federal income return on a calendar year basis. In Year-1, Taxpayer claimed a deduction of $a for losses from capital assets sold or exchanged to provide funds to meet abnormal insurance loss under § 832(c)(5) in computing its separate taxable income. In order to compute this "abnormal capital loss" deduction, Taxpayer first compared the sum of its cash expenditures during the taxable year with respect to policyholder dividends, losses, and expenses to the sum of its cash receipts with respect to items included in gross investment income (exclusive of capital gains) and net premiums received. This calculation resulted in a excess of cash disbursements over cash receipts of $b. Pursuant to the quantitative test set forth in § 832(c)(5), Taxpayer treated capital assets sold or exchanged during the taxable year up to the amount of this cash flow deficit as "forced sales" for the purpose of obtaining funds to pay abnormal insurance losses and policyholder dividends.

Taxpayer made an extensive number of sales or exchanges of capital assets during Year-1, resulting in gross receipts which substantially exceeded the maximum amount provided in

§ 832(c)(5) for abnormal loss purposes. Accordingly, it was necessary for Taxpayer to identify the specific sales during the taxable year which would be taken into account in determining the abnormal capital loss deduction. For this purpose, Taxpayer identified 23 sales transactions, resulting in losses of $a. The identified sales transactions occurred throughout the taxable year and were apparently selected by Taxpayer because they produced the greatest deductible loss in proportion to their total gross receipts.

The examining agent has proposed to adjust Taxpayer's abnormal capital loss deduction by chronologically tracing Taxpayer's sales of capital assets, beginning with the first sale during the taxable year, until the gross receipts on those sales are equal to the maximum limitation on qualifying sales set forth in § 832(c)(5). If this chronological tracing procedure is adopted, the amount of Taxpayer's abnormal capital loss deduction would be reduced to $c.

You have requested our views whether the examining agent's use of a chronological tracing method to select qualified sales transactions for purposes of the abnormal loss deduction under § 832(c)(5) is appropriate.

Law and Analysis

Section 832(b)(1)(B) provides that the gross income of an insurance company which is taxable under § 831 includes gain during the taxable year from the sale or disposition of property.

Section 832(c)(5) allows an insurance company a deduction for capital losses to the extent provided in subchapter P (i.e., §§ 1201 and following, relating to capital gains and losses) plus losses from capital assets sold or exchanged in order to obtain funds to meet abnormal insurance losses and to provide for the payment of dividends and similar distributions to policyholders. The statutory provision sets out a quantitative test for determining when capital assets are considered sold or exchanged in order to obtain funds to pay abnormal insurance losses and dividends to policyholder. Under this quantitative test, capital assets are considered as sold or exchanged in order to obtain funds to meet abnormal insurance losses and to provide for the payment of dividends to policyholder to the extent that the gross receipts from their sale are not greater than the excess, if any, for the taxable year of (1) the sum of the insurance company's cash expenditures with respect to policyholder dividends, losses, and expenses, over (2) the sum of the insurance company's gross receipts with respect to investment income items (excluding capital gains) and net premiums received.

The general rule under § 1211(a) is that a corporation can deduct its capital losses only to the extent of its capital gains and cannot offset a net capital loss against ordinary income. Under § 1212(a) a corporation's net capital loss becomes a capital loss carryback and carryover and is treated as a short term capital loss in the year to which carried. Section 832(c)(5) provides limited relief from this general rule by permitting an insurance company to treat losses with respect to sales or exchanges of capital assets which, in accordance with the statute's quantitative test, are considered to be made for the purpose of obtaining funds to pay abnormal insurance losses as a deductions from ordinary income, rather than becoming a net capital loss carryback and carryover under § 1212(a).

Section 832(c)(5) also modifies the general rule set forth in § 1212 relating to capital loss carrybacks and carryovers to prevent the amount of losses deducted from ordinary income under the abnormal capital loss provision from being taken into account twice. In applying § 1212 for this purpose, the net capital loss for the taxable year equals the amount by the capital losses for the taxable year exceeds the capital gains for such year plus the lesser of either (1) the taxable income computed without regard to gains or losses from sales or exchanges of capital assets, or (2) losses from the sale or exchange of capital assets sold or exchanged to obtain funds to provide for the payment of abnormal insurance losses.

Section 1.832-5(a) of the Income Tax Regulations states that the abnormal capital loss deduction allowed by (§ 832(c)(5) is the same as that previously allowed by § 822(c)(6) in the case of a mutual insurance company (other than a life insurance company) for purposes of the tax imposed under former § 821.[1] Accordingly, the regulations under § 1.822-8(c)(6), which address the treatment of capital losses in applying former § 822(c)(6), also apply for purposes of the abnormal capital deduction of § 832(c)(5).

Section 1.822-8(c)(6)(i) states, in part, that the deduction for capital losses under § 822(c)(6) includes not only capital losses to the extent provided in subchapter P, but in addition, losses from capital assets sold or exchanged to provide funds to meet abnormal insurance losses and to provide for the payment of policyholder dividends. Losses in the latter case may be deducted from ordinary income while the deduction for capital losses under subchapter P is limited to the gains.

The rule in former § 822(c)(6) for determining when capital assets are deemed to be sold for the purpose of obtaining funds to pay abnormal insurance losses is the same as that provided in § 832(c)(5), specifically, that capital assets shall be considered as sold for this purpose to the extent that the gross receipts from their sale are not greater than the excess, if any, for the taxable year of (1) the sum of the insurance company’s cash expenditures with respect to policyholder dividends, losses, and expenses, over (2) the sum of the insurance company’s gross receipts with respect to investment income items (excluding capital gains) and net premiums received.

Section 1.822-8(c)(6)(ii) provides, in part, that if by reason of a particular sale or exchange of a capital asset, gross receipts are greater than the excess referred to in § 822(c)(6), the gross receipts and resulting loss should be apportioned and the excess included in capital losses subject to the provisions of subchapter P.

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[1] In the Tax Reform Act of 1986, the provisions of Part II and Part III of subchapter L, which had distinguished between mutual insurance companies (other than life insurance companies) and other insurance companies, were consolidated into a single Part II. Under the 1986 Act, therefore, all insurance companies other than life insurance companies are taxed under Part II of subchapter L (Sections 831 through 835). As a result of this consolidation, the abnormal capital loss provision available to mutual insurance companies (§ 822(c)(6)) was repealed, and replaced by a single provision which applies to both stock and mutual insurance companies.

Section 1.822-8(c)(6)(iii) provides a series of examples which illustrate how this apportionment is made. Examples (1) and (2) are particularly relevant to the issue raised in your request. Both examples involve situations where, under the rule set forth in § 822(c)(6), the maximum amount of sales or exchanges of capital assets which may be considered to be made in order to obtain funds for the payment of abnormal insurance losses and policyholder dividends equals $75,000. In Example (1), the insurance company had total gross receipts from sales of capital assets during the taxable year of $60,000, resulting in losses of $20,000. Because the insurance company's gross receipts from sales of capital assets are less than the maximum amount set forth in § 822(c)(6), the example provides that the company treats all of its sales of capital assets during the taxable year as made for the purpose of obtaining funds to pay abnormal insurance losses.

In contrast, in Example (2), the insurance company's gross receipts from sales of capital assets during the taxable year totaled $76,000, resulting in losses of $20,000. Example (2) also indicates that the insurance company's "last sale" resulted in gross receipts of $2,000 and a loss of $500. Thus, in this example, "[t]he last sale made the gross receipts of $76,000 exceed by $1,000" the maximum amount of qualifying sales set forth in § 822(c)(6). Consequently, Example (2) indicates that the gross receipts and loss on the "last capital asset sold" must be apportioned based on this $1,000 excess. Under the Example, this apportionment is made by comparing the remainder of the maximum amount set forth in § 822(c)(6) prior to the "last sale" to the gross receipts generated by this "last sale." Accordingly, in Example 2, "[t]he gross receipts and the resulting loss are apportioned on the basis of the ratio of the excess of $1,000 to the gross receipts of $2,000, or 50 percent. Fifty percent of the loss of $500 is deducted from the total loss of $20,000. The remaining gross receipts of $1,000 and the proportionate loss of $250 should be reported as capital losses under subchapter P."

Section 832(c)(5) provides that capital assets are considered sold or exchange in order to obtain funds to meet abnormal insurance losses only to the extent the gross receipts from their sale are not greater than the excess of the insurance company's cash disbursements with respect to specified items over gross receipts with respect to specified items. Once the insurance company's gross receipts from sales transactions during the taxable year exceed this maximum amount, all further sales or exchanges of capital assets are considered "nonqualifying sales," so that any losses realized on those sales are subject to the general provisions of subchapter P rather than deductible against ordinary income. As a result, the determination of which specific assets are considered sold or exchanged to obtain funds to abnormal insurance losses is not based on the subjective intent of the insurance company, but rather on the quantitative test set forth in the statute.

Section 1.822-8(c)(6)(ii) further provides that if, by reason of particular sale or exchange of a capital asset, the insurance company's gross receipts from sales of capital assets during the taxable year are greater than the excess of cash disbursements over cash receipts, the gross receipts and resulting loss attributable to that transaction must be apportioned so that part of the loss is not treated as an abnormal capital loss. The manner of making this apportionment is illustrated is Example (2) of § 1.822-8(c)(6)(iii). This example refers to the "last sale" and the "last capital asset sold." Accordingly, Example (2) of § 1.822-8(c)(6)(iii) implies that all sales preceding this "last sale" in point of time have been applied against the maximum limitation set forth in § 822(c)(6) in determining qualified sales for purposes of the abnormal capital loss deduction. Once the gross receipts and resulting loss on this "last sale" are apportioned, all further sales or exchanges of capital assets are considered nonqualifying sales, so that any losses attributable to those transactions must be taken into account under the general rules of subchapter P.

In light of the apportionment rule set forth in § 1.822-8(c)(6)(ii), and the illustrative computation set forth in Example (2) of § 1.822-8(c)(6)(iii), we believe that a chronological tracing of gross receipts from sales of capital assets during the taxable year up to the maximum amount provided in § 832(c)(5) is a proper means of identifying qualifying sales for purposes of the abnormal capital loss deduction. Application of a chronological tracing of gross receipts up to the maximum amount provided in § 832(c)(5) is not inconsistent with the apparent legislative intent to provide limited relief to an insurance company from the hardship of a forced sale of assets in years when the company has abnormal insurance losses. Moreover, this chronological tracing approach avoids the difficult administrative problems that would arise if an insurance company were required to demonstrate factually from internal records which specific sales throughout the taxable year were in fact made to obtain funds to pay abnormal insurance losses.

CASE DEVELOPMENT, HAZARDS, AND OTHER CONSIDERATIONS

Although the apportionment rule in § 1.822-8(c)(6)(ii) and the illustrative computation in Example (2) of § 1.822-8(c)(6)(iii) may be reasonably interpreted as requiring a chronological tracing of gross receipts from sales transactions up to the maximum amount allowed by § 832(c)(5) in order to identify which capital assets are deemed to be sold to pay for abnormal losses, this interpretation is not irrefutable. For example, the references in the example to the "last sale" and "last capital asset sold" may possibly refer to the terminal point of a series of sales transactions which are classified on some other basis than time. As a further example, if the insurance company made no further sales of capital assets during the taxable year after this "last sale," the apportionment of gross receipts and the resulting loss in Example (2) is no different than the results that would have obtained if the insurance company had made this apportionment based on its total gross receipts and losses throughout the taxable year. See GCM 32642, CC:I-546 (August 12, 1963), which approved of a chronological tracing method to identify qualifying sales but noted the possibility of alternative interpretations of the references in Example (2) of § 1.822-8(c)(6)(iii) to "last sale" and "last capital asset sold."

In addition, it may be argued that the chronological ordering rule suggested by Example (2) of § 1.822-8(c)(6)(iii) should not be imposed in all circumstances which an insurance company has gross receipts from sales of capital assets during the year which exceed the maximum amount provided in § 832(c)(5). That is, it is well established that examples in Treasury regulations are generally considered to be simply illustrations of how a particular rule would apply in certain selected situations, and nor exhaustive or exclusive explications of that rule. See, e.g., Tennessee Baptist Children's Home, Inc. v. United States, 790 F.2d 534, 539 (6th Cir. 1986) ("[E]xamples incorporated in Treasury Regulations are generally considered illustrative only."). [redacted]

[redacted]

If you have further questions conerning this memorandum, please contract Don Drees or Gary Geisler, at (202) 622-4433 or (202) 622-3623, respectively.