

## Issue Paper No. 149

### Wholly-Owned Single Real Estate Property in an LLC

#### STATUS

Finalized December 12, 2014

#### Original SSAP and Current Authoritative Guidance: SSAP No. 40R

*Also refer to SSAP No. 48.*

#### Type of Issue:

Common Area

#### SUMMARY OF ISSUE

1. Current statutory accounting guidance for real estate investments is in *SSAP No. 40—Real Estate Investments* (SSAP No. 40), and guidance for investments in joint ventures, partnership, and limited liability companies (LLC) is in *SSAP No. 48—Joint Ventures, Partnerships and Limited Liability Companies* (SSAP No. 48). Reporting entities can own real estate through an LLC to provide a liability shield against the risks of holding real estate. Single property real estate that is wholly-owned (100%) by a single reporting entity in an LLC, if specific criteria are met, is in substance a real estate investment.
2. This issue paper provides substantive revisions to incorporate individual real estate investments wholly-owned by a single entity through an LLC, which meet specific criteria, within the scope of SSAP No. 40. The revisions also exclude these investments from SSAP No. 48.

#### SUMMARY CONCLUSION

3. This issue paper substantively revises the scope of SSAP No. 40 and SSAP No. 48. The substantive revisions to SSAP No. 40 and SSAP No. 48 are shown below.

#### Substantive Revisions to SSAP No. 40:

2. Real estate investments are defined as directly-owned real estate properties and single real estate property investments that are directly and wholly-owned through a limited liability company (LLC) that meet all of the criteria in paragraph 4. ~~These~~ Real estate investments may be acquired in exchange for consideration (including but not limited to cash, a contract for deed or mortgage, or other non-cash consideration), obtained through foreclosure or voluntary conveyance in satisfaction of a mortgage loan, or received as contributed surplus. Real estate investments meet the definition of assets as defined in *SSAP No. 4—Assets and Nonadmitted Assets* and are admitted assets to the extent they conform to the requirements of this statement.
3. Real estate investments include certain acquisition, development and construction arrangements (ADC) as defined in *SSAP No. 38—Acquisition, Development and Construction Arrangements* (SSAP No. 38).
4. A single real estate property investment that is wholly-owned by an LLC that is directly<sup>1</sup> and wholly-owned by the reporting entity shall be captured within this statement, and reported on Schedule A – Real Estate if all of the following criteria are met. Real estate owned through an

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<sup>1</sup> For example, qualifying LLCs that are owned by a downstream holding company are not within scope of this statement regardless if the downstream holding company is wholly-owned by the reporting entity.

LLC that meets the stated criteria shall follow all statutory requirements within this statement<sup>2</sup>. Real estate owned through an LLC that does not meet the criteria shall be reported on Schedule BA – Other Long-Term Invested Assets. Regardless if reported on Schedule A or Schedule BA, all LLC's owned by the reporting entity shall be detailed in Schedule Y.

- a. The real estate LLC has no transactions of its own other than transactions associated with an ownership structure utilized only for the ownership and management of a single real estate investment exclusively for the reporting entity (e.g., real estate taxes). A reporting entity may have more than one LLC that wholly-owns a single real estate property investment, but each LLC must separately comply with the paragraph 4 conditions, and be separately reported on Schedule A. All transactions of the LLC shall be reported as transactions of the reporting entity pursuant to the guidance in paragraphs 15-17.
- b. The LLC only owns a single real estate property supported by an appraisal pursuant to paragraphs 13-14. A single real estate property can include multiple parcels of land and more-than-one structure; however, to be considered a single real estate property, the multiple of parcels of land and structure(s) must be contiguously located and managed together as a single asset (with reasonable allowances for public access routes). Criteria that may assist with determining a single real estate property would include the legal definition of the property, real estate tax assessments, postal address, the appraisal and the management and use of the property.
- c. The reporting entity solely controls the real estate property in a manner similar to directly-owned real estate. As such, the reporting entity controls others' access to the real estate, and the real estate must be able to be sold exactly as, and as promptly as, directly-owned real estate.
- d. The reporting entity solely and distinctly possesses all risks (other than the limitation of potential liability afforded by the LLC structure itself) and rewards of ownership of the real estate investment, without any constraints imposed by the LLC.
- e. The reporting entity is the only member of the LLC. The LLC is not comprised of any other members, including: groups, competing interests, mutual beneficial interests, or co-venturers. The single-member ownership is required even if other members in the LLC are affiliates. An LLC comprised of affiliated parties is not within scope of this statement.
- f. There shall be no apportionment by the LLC or the reporting entity of the appraised value, expenses or income from the single real estate property to any other entity or between the general or separate account.

#### Disclosures (New Paragraph 27)

27. An entity that holds real estate investments through an LLC, which qualifies for inclusion in this statement because all the criteria in paragraph 4 are met, shall separately report each investment on Schedule A, and code the real estate as wholly-owned through an LLC.

#### Effective Date and Transition (New Paragraphs 36-37)

36. The substantive revisions to incorporate real estate property investments that are wholly-owned by an LLC that is directly and wholly-owned by the reporting entity in accordance with the

<sup>2</sup> The inclusion in this statement of real estate owned by a single member LLC is not an election by the reporting entity. All real estate owned in an LLC meeting the criteria in paragraph 4 are required to be captured within this statement, and are subject to this statement's requirements for valuation and admittance. Departures from the requirements within this SSAP, or continuing to follow SSAP No. 48 for these investments would be considered a departure from NAIC statutory accounting principles subject to permitted or prescribed practice disclosure requirements.

criteria detailed in paragraph 4 are effective as of January 1, 2015. For these investments previously reported within SSAP No. 48, and owned as of the effective date, the reporting entity shall recognize a cumulative effect of a change in accounting principle as if the entity had followed this statement since acquisition of the real estate investment property. The change from applying these substantive revisions shall be accounted for as a change in accounting principle in accordance with SSAP No. 3—Accounting Changes and Corrections of Errors.

37. To determine statement value for real estate owned through an LLC as of the paragraph 36 effective date, the reporting entity shall:

- a. Allocate the original cost of the real estate investment to land and property other-than-land pursuant to paragraph 8.
- b. To arrive at the current depreciated cost for property (excluding land), the entity shall apply the depreciation that would have occurred if this statement had been applied since acquisition, in accordance with the original expected useful life, adjusted for subsequent capital improvements pursuant to paragraph 16.
- c. The depreciated cost calculated under paragraph 37.b. shall be compared to a current appraisal to determine if an impairment assessment is required under SSAP No. 90. Recognition of impairment shall result in a new cost basis for the property, with recalculation of the depreciation based on the property's remaining useful life, as limited by the terms of this statement.
- d. The depreciated cost, reflecting any impairment from paragraph 37.c., less encumbrances, shall be recognized as the real estate investment as of the effective date.

#### **Substantive Revisions to SSAP No. 48:**

##### **SCOPE OF THE STATEMENT**

1. This statement establishes statutory accounting principles for investments in any joint ventures, partnerships, and limited liability companies, including investments in certified capital companies (CAPCO) per *INT 06-02: Accounting and Reporting for Investments in a Certified Capital Company (CAPCO)*, whether or not it is considered to be controlled by or affiliated with the reporting entity. Single real estate property investments that are wholly-owned by an LLC that is directly and wholly-owned by the reporting entity, and that meet the criteria established in SSAP No. 40—Real Estate Investments, are excluded from this statement. This statement does not address the accounting for investments in partnerships and limited liability companies that invest in Low Income Housing Tax Credit Properties as discussed in *SSAP No. 93—Accounting for Low Income Housing Tax Credit Property Investments* (SSAP No. 93). However, investments in certain state Low Income Housing Tax Credit Property Investments that do not fall within the scope of SSAP No. 93 are covered by the requirements of this statement.

##### **EFFECTIVE DATE AND TRANSITION (NEW PARAGRAPH 26)**

26. The substantive revisions to incorporate single real estate property investments wholly-owned by an LLC that is directly and wholly-owned by the reporting entity in accordance with the criteria detailed in SSAP No. 40 are effective as of January 1, 2015. For these investments previously reported within the scope of this statement, the reporting entity shall follow the transition guidance in SSAP No. 40.

##### **DISCUSSION**

4. In August 2013, a sponsor submitted an agenda item (Ref #2013-17) to the Statutory Accounting Principles (E) Working Group recommending revisions to indicate that if the substance of a real estate transaction means that absolute control and all rights over the real estate are with the insurer, and just the

insurer, then the accounting and reporting should be in accordance with *SSAP No. 40—Real Estate Investments* and *SSAP No. 90—Accounting for the Impairment or Disposal of Real Estate*.

5. Within the submitted agenda item, the sponsor advocated that for these transactions, the arm's length economic transaction is the purchase of real estate, not an investment in an LLC. The single member / single asset LLC is a conduit that one invests "through" not "in," and the insurer's control over the real estate is total and absolute, as control is equivalent to direct ownership. The sponsor noted that the insurer can establish absolute control equivalent to direct ownership by meeting all of the following conditions:

- a. The insurer controls others' access to the real estate to the extent that the real estate is the "asset" with an appraisal. It can be sold exactly as and, as promptly as, any other real estate sale. From the perspective of *SSAP No. 4—Assets and Nonadmitted Assets* (SSAP No. 4), it is real estate that is the asset standing ready to satisfy policy owner needs;
- b. Risks and rewards of ownership of the real estate as discussed in *SSAP No. 25—Accounting for and Disclosures about Transactions with Affiliates and Other Related Parties* (SSAP No. 25), are solely and distinctly in possession of the insurer without any constraints imposed by the LLC with constraints defined as in *SSAP No. 103—Accounting for Transfers and Servicing of Financial Assets and Extinguishment of Liabilities* (SSAP No. 103);
- c. No members are in the single-member/single asset LLC except for the insurer itself, no "group" or competing interest, "mutual" beneficial interest or "co venturer", affiliated or not, having any ownership interest in the real estate as anticipated by SSAP No. 48;
- d. The single-member/single-asset LLC has no transactions of its own;
- e. Lacking any interests outside of the insurer's general account, there is absolutely no need or reason to apportion the appraised value, expenses or income from the real estate. All accounting requirements of SSAP No. 40 are met to the extent that the asset could reasonably meet the comment in Schedule BA instructions that it could be "normally includable" in Schedule A;
- f. The LLC is not a business in itself but is an administrative device. It follows the model of an "Investment Affiliate" in RBC Instructions that is organized to engage in the ownership and management of investments exclusively for the insurer for which risk based capital factors are those of the underlying asset; and,
- g. The insurer will disclose use of single-member/single-asset LLCs as required by *SSAP No. 1—Disclosure of Accounting Policies, Risk and Uncertainties, and Other Disclosures* (SSAP No. 1).

6. In reviewing the sponsor-submitted agenda item, NAIC staff identified that some real estate transactions are separately housed in LLC structures for legal liability reasons, and under existing statutory accounting guidance, these wholly-owned structures would be within the scope of SSAP No. 48, and be reported using an equity method as defined in *SSAP No. 97—Investments in Subsidiary, Controlled or Affiliated Entities* (SSAP No. 97). Pursuant to guidance in SSAP No. 97, these investments would be considered U.S. noninsurance SCA entities and be recorded based on the audited U.S. GAAP equity of the investee.

7. In identifying the differences that would occur if these real estate structures were moved to SSAP No. 40, NAIC staff noted the following:

- a. Reduction of RBC: For real estate reported on Schedule A (SSAP No. 40), the health/P&C RBC charge is 0.10 of the book/adjusted carrying value and 0.10 of the encumbrances, the life RBC charge is 0.15 of the book/adjusted carrying value and 0.12 of the encumbrances. For life annual statement filers, these investments reported on Schedule BA through an LLC receive a 0.23 RBC pre-tax charge on the book/adjusted carrying value, with an additional 0.20 pre-tax charge on the encumbrances. For property and health annual statement filers, these investments receive a 0.20 RBC charge on the book/adjusted carrying value.
  - b. Reduction of Carrying Value: Real estate accounted for under SSAP No. 40 is valued at depreciated cost, and generally reported at depreciated cost less encumbrances. (Property held for sale is reported at the lower of fair value, or depreciated cost less encumbrances.)
  - c. Depreciating Asset: Real estate property other than land accounted for under SSAP No. 40 is depreciated over its estimated useful life, not to exceed fifty years. Expenditures to put the real estate asset back into good condition or to keep it in good operating condition are expensed as incurred. Expenditures that add or prolong the life of the property are added to the cost of the property and depreciated over the remaining estimated useful life.
  - d. Admitted Asset Restrictions: Real estate property held for the production of income, or held for sale under SSAP No. 40 are required to have a current appraisal. A current appraisal is defined as one that is no more than five years old. Property not supported by a current appraisal is nonadmitted. Under SSAP No. 48, investments in an LLC were nonadmitted if not supported by audited financial statements.
  - e. Disallowance of Fair Value Gains: Real estate properties held under SSAP No. 40 are not permitted to reflect fair value increases in value.
8. In December 2013, after initially exposing the agenda item for comment, and submitting a referral to the Capital Adequacy (E) Task Force, the Statutory Accounting Principles (E) Working Group noted that comments received from interested parties supported the concepts and conditions within the agenda item. Additionally, the comments requested an expansion of the scope of the agenda item to include multi-member insurers and real estate held in a holding company system. In discussing this proposed expansion, the Working Group agreed to limit consideration to single-member/single-asset situations, and potentially consider a broader project under the investment classification project (Ref #2013-36).
9. In August 2014, the Statutory Accounting Principles (E) Working Group considered comments from the Capital Adequacy (E) Task Force and directed staff to proceed with drafting guidance to incorporate these assets into SSAP No. 40 with a caveat that the guidance could be amended under the Working Group's current investment classification project. In discussing this option, representatives from interested parties' stated support for this approach, and noted that the proposed move between SSAPs would be fairly easy to incorporate within their financial reporting systems.
10. During the August 2014 discussion, NAIC staff clarified that the current Working Group direction would be to draft guidance to not allow optionality in determining whether the real estate assets fall within SSAP No. 48 or SSAP No. 40, therefore the assets that meet the criteria would be solely captured within SSAP No. 40. This discussion highlighted that this change would allow a reporting change from Schedule BA to Schedule A, resulting in a lower RBC charge, but the change would also possibly result in a lower asset value, as SSAP No. 40 requires a depreciated cost value net of encumbrances instead of GAAP equity. Additionally, under SSAP No. 40, an appraisal is required for the asset to be admitted, and an appraisal is not required for the asset to be admitted under SSAP No. 48. Comments received from Working Group members stated support for the improved reporting

transparency if these investments were captured under SSAP No. 40, and noted that industry seems aware of the accounting impact that will occur with implementation of these changes.

## **EFFECTIVE DATE**

11. Upon adoption of this issue paper, the NAIC will release a substantively revised statement of statutory accounting principles (SSAP) for comment. The SSAP will contain the adopted Summary Conclusion of this issue paper. Users of the *Accounting Practices and Procedures Manual* should note that issue papers are not represented in the Statutory Hierarchy (see Section IV of the Preamble) and therefore the conclusions reached in this issue paper should not be applied until the corresponding SSAP has been adopted by the Plenary of the NAIC. It is expected that the SSAP will contain an effective date of reporting periods after January 1, 2015.

## **RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE**

### **Statutory Accounting**

- *SSAP No. 40—Real Estate Investments*
- *SSAP No. 48—Joint Ventures, Partnerships and Limited Liability Companies*
- *SSAP No. 90—Accounting for the Impairment or Disposal of Real Estate Investments*

### **Generally Accepted Accounting Principles**

- The above mentioned SSAPs have several GAAP references. As this issue paper is specific to statutory accounting reporting between SSAPs, the GAAP guidance has not been duplicated.