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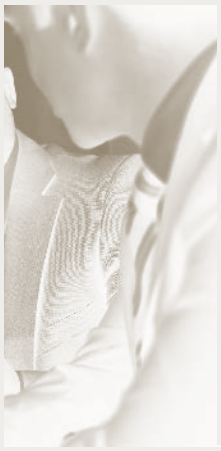

IRS CONCLUDES IN CCA THAT SECTION 197 APPLIES TO ALL SECTION 1060 INDEMNITY REINSURANCE TRANSACTIONS

By Lori J. Jones

In an interesting start to the new year, the Internal Revenue Service (IRS) released guidance which concluded that section 197[1] requires the capitalization and amortization of a ceding commission in excess of the amount capitalized under section 848 in "any" section 1060 transaction involving an insurance business. Section 197(f)(5) provides rules to determine the amount of an amortizable section 197 intangible resulting from an assumption reinsurance transaction. In Chief Counsel Advice (CCA) 201501011 (Sept. 4, 2014), the IRS concluded that section 197 applies to a ceding commission regardless of whether the transfer of the insurance business occurs pursuant to an underlying assumption reinsurance or indemnity reinsurance transaction. When the regulations under sections 338 and 1060 were being finalized in 2006, commentators asked for clarification that a ceding commission is deductible under section 848(g) in an indemnity reinsurance transaction even if the overall transaction is subject to section 1060. The clarification was not made and no explicit clarification (supporting either conclusion) was included at that time.[2] It is unfortunate that the guidance on this significant issue is being offered by the IRS only in the form of a CCA. Moreover, the analysis set forth in the CCA raises questions as to its validity.

Summary of Facts

In the CCA, the parties entered into a Master Asset Purchase Agreement (Agreement) whereby Taxpayer purchased certain assets used in Seller's life reinsurance business, including workforce in place and certain fixed assets. The parties also entered into a retrocession agreement for a specified number of Seller's life reinsurance contracts. The Agreement recital provided that Taxpayer wished to assume this portion of Seller's business on a 100-percent coinsurance indemnity basis and that Seller also would enter into an Assumption Agreement whereby Seller agreed to use commercially reasonable efforts to ensure that Taxpayer assumed, on a novation basis, each of the life reinsurance agreements. The facts state that, by Date 2, a certain percentage of the retroceded contracts had been novated to Taxpayer, and, by Date 3, all of the contracts were novated. The actual dates and their proximity in time are not identified in the redacted version of the CCA.

Taxpayer treated the transaction as indemnity reinsurance under SSAP 61 and stated that the transaction was a section 1060 applicable asset acquisition. For federal income tax purposes, Taxpayer deducted the amount of the ceding commission in excess of the amount capitalized under section 848 because in Tax Year 1 Seller remained liable to the original ceding companies. None of the novations were completed before Date 4. (This suggests that Date 4 is before Date 2.) Consequently, in that case, Taxpayer argued that section 197(f)(5) did not apply and the ceding commission in excess of the amount required to be capitalized under section 848 was fully deductible under section 848(g) (which provides that no rule other than section 848 or 197 requires the capitalization of any ceding commission).

The IRS relied on two arguments to support its conclusion. The first was that the overall transaction was in substance an assumption reinsurance agreement to which section 197 applied even though it was initially structured as an indemnity reinsurance agreement. The second was that section 197 requires capitalization of any ceding commission without regard to whether the underlying reinsurance itself is assumption or indemnity reinsurance if the overall transaction qualifies under section 1060, i.e., there is reinsurance as well as an applicable asset acquisition.[3]

CCA: The Transaction Should Be Treated as Assumption Reinsurance

The IRS noted that, even though the Agreement recital supported Taxpayer's position that the retrocession was on a 100-percent indemnity coinsurance basis, the contract as a whole included language of an assumption reinsurance agreement. As a result, the CCA held that there were sufficient facts to conclude the Agreement was an "assumption retrocession" contract.[4] The IRS relied on the fact that the Entire Agreement

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incorporated the Assumption and Novation Agreements and the Agreement indicated Seller's intent to sell and exit the life reinsurance business.

Treas. Reg. § 1.197-2(g)(5) contains rules on the treatment of certain insurance contracts acquired in an assumption reinsurance transaction. The regulations apply to:

- assumption reinsurance which is defined in Treas. Reg. § 1.809-5(a)(7)(ii) as, "an arrangement whereby another person (the reinsurer) becomes solely liable to the policyholders on the contracts transferred by the taxpayer. Such term does not include indemnity reinsurance or reinsurance ceded (as defined in paragraph (a)(1)(iii) of section 1.809-4);"

- the transfer of insurance or annuity contracts and the assumption of related liabilities deemed to occur by reason of a section 338 election for a target insurance company which is treated as an assumption reinsurance transaction; and

- the transfer of a reinsurance contract by a reinsurer (transferor) to another reinsurer (acquirer) that is treated as an assumption reinsurance transaction if the transferor's obligations are extinguished as a result of the transaction.

In the CCA, at the time the ceding commission was paid, the relevant agreement was the indemnity reinsurance agreement and Seller had continuing obligations to the ceding companies.

By treating the overall transaction as an assumption reinsurance agreement subject to section 197(f)(5) in Year 1, the IRS appears to rely on the step-transaction doctrine. No authority is cited in the CCA. The IRS could have relied on the last category in the regulation described above, i.e., the transfer of a reinsurance contract by a reinsurer (transferor) to another reinsurer (acquirer) is treated as an assumption reinsurance transaction if the transferor's obligations are extinguished as a result of the transaction, since it treated all parts of the transaction as one.

In the context of retrocessions, the CCA's application of the step-transaction doctrine may have some merit where extinguishments of the original ceding company's obligations to the direct writer are forthcoming and previously negotiated. Extension of the CCA's analysis to indemnity reinsurance where approval of policyholders to a novation of the direct writer's obligation is required would be troublesome and result in uncertainty without further guidance. It is difficult to see how the step-transaction doctrine can apply where the second step (contract novation) is dependent on multiple third-party consents.

CCA: Section 197 Applies to Indemnity Reinsurance in a Section 1060 Transaction

The more troubling analysis is the conclusion that section 197 applies to any section 1060 transaction even if the underlying reinsurance is indemnity reinsurance. The IRS appears to be adopting a much broader approach to the application of section 197(f)(5) and one which is outside the authority of both the statute and the regulations.[5] The CCA states that Taxpayer failed to address why the regulations under sections 1060, 338 and 197 did not apply to the transaction. It then states that, "If they do, whether Taxpayer entered an assumption or indemnity arrangement with Seller does not determine how it treats the ceding commission for federal income tax purposes (and precludes consideration of whether Arrangement is an assumption or indemnity retrocession contract)." The CCA further concludes that it is "clear" in the residual method rules that an indemnity reinsurance contract is a Class VI asset, section 197 intangible, and it is "clear" the residual method rules treat section 338 and 1060 acquisitions as deemed assumption reinsurance arrangements. The CCA then concludes that, because the section 338 regulations treat the deemed sale of insurance contracts as an assumption reinsurance transaction for federal income tax purposes, and the regulations apply to section 1060 acquisitions, a "section 1060 acquisition is likewise treated as an assumption reinsurance transaction." In conclusion, the CCA holds that Taxpayer must capitalize under section 197 the portion of the ceding commission in excess of the amount capitalized under the DAC provisions.

The IRS' conclusion ignores the basic reason for the limitation of section 197(f)(5) to assumption reinsurance transactions in the first place. An assumption reinsurance transaction results in the transfer of all the value of an intangible asset—the insurance in force. Thus, it makes sense to amortize any ceding commission paid in an assumption reinsurance transaction pursuant to section 197(f)(5). In contrast, an indemnity reinsurance transaction typically is not a permanent transfer of the same intangible asset. Instead, the intangible asset acquired by the reinsurer is merely the contractual rights under the reinsurance contract. The different nature of the intangible asset acquired is reflected by the fact that the direct obligation to

the policyholders remains with the ceding company whereas that obligation is extinguished in the context of assumption reinsurance, and the indemnity reinsurance agreement often contains recapture provisions that allow the agreement to be terminated, thus having the effect of transferring the business back to the ceding company.

The general rule in Treas. Reg. § 1.197-2(g)(5)(i) (set forth above) contains no cross-reference to the section 1060 regulations. In fact, by referring to the definition of assumption reinsurance in Treas. Reg. § 1.809-5(a)(7)(ii), the section 197 regulations exclude indemnity reinsurance from the scope of section 197(f)(5) with no mention of the exclusion being limited to those ceding commissions that are *not* acquired or paid in connection with a transaction to which the section 1060 allocation rules apply. Further, the reference in the section 197 regulations to an acquisition in connection with a section 338 election should not be read to include transactions which do not involve an actual section 338 election such as those subject to section 1060. The CCA makes the puzzling suggestion that the legislative history to section 197(f)(5) expresses a Congressional intent that indemnity reinsurance acquired in a section 338 asset acquisition could be a section 197 intangible. It is difficult to see how indemnity reinsurance would be used in a section 338 fictional deemed asset sale.

Moreover, section 1060 contains special allocation rules for certain asset acquisitions and Treas. Reg. § 1.1060-1(c) only provides a rule for the allocation of consideration among assets. Treas. Reg. § 1.1060-1(c)(5) applies to the acquisition under section 1060 of an insurance business and states that the section 1060 rules are modified by the principles of § 1.338-11(a) through (d) (which provide that if a target is an insurance company, the deemed sale of insurance contracts is treated for Federal income tax purposes as an assumption reinsurance transaction.) These principles apply only in the context of section 1060 for purposes of determining the amount allocable to the insurance contracts and do not govern whether section 197 applies to the overall transaction.

The reference to the section 338 regulations in Treas. Reg. § 1.1060-1(c)(5) only applies to determine the proper allocation of consideration among the acquired assets and does not address whether any portion of the ceding commission is subject to section 197, as assumed in the CCA. Section 197(f)(5) requires capitalization in the case of assumption reinsurance transactions. Treas. Reg. § 1.197-2(g)(5)(ii)(B) states that the amount paid or incurred by a reinsurer *under an assumption reinsurance transaction* includes the amount allocated under section 1060. Thus, section 197 and the regulations require that the transaction be an assumption reinsurance transaction first. This is consistent with the statement in the Notice of Proposed Rulemaking that added Treas. Reg. § 1.1060-1(c)(5) which stated: "the rules in the proposed regulations under section 197 also apply to reinsurers of insurance business in transactions governed by section 1060 if effected through assumption reinsurance." REG-118861-00 (Mar. 8, 2002), 2002-1 C.B. 651.

Finally, contrary to the CCA's assertion, it is not clear that a Class VI asset is always a section 197 intangible. Treas. Reg. § 1.338-6(b)(2)(vi) states that Class VI assets are "all section 197 intangibles, as defined in section 197, except goodwill and going concern value." Treas. Reg. § 1.1060-1(c)(5) implicitly provides an exception to this rule and states that, "…in transactions governed by section 1060, such principles apply even if the transfer of the trade or business is effected in whole or in part through indemnity reinsurance rather than assumption reinsurance, and, for the insurer or reinsurer, an insurance contract (including an annuity or reinsurance contract) is a Class VI asset *regardless of whether it is a section 197 intangible."* (Emphasis added). This language only makes sense if it is possible that the ceding commission in a section 1060 indemnity reinsurance transaction may not always be a payment for a section 197 intangible. Second, the CCA is incorrect in stating it is "clear" that the residual method rules treat section 338 and 1060 transactions as deemed assumption reinsurance arrangements for all purposes. As noted above, the application of the deemed assumption reinsurance rules only affects the allocation of consideration among assets under section 1060. The CCA is not relying on either section 848 or 197 to impose capitalization, but rather on section 1060—a questionable conclusion.

In conclusion, the CCA raises numerous questions as to whether it is appropriate to capitalize a ceding commission under section 197(f)(5) in the context of an indemnity reinsurance transaction merely because the transaction is otherwise subject to section 1060. ◂

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END NOTES

[1] References to section are to sections of the Internal Revenue Code of 1986, as amended, unless otherwise indicated.

[2] The preamble states that, "Commentators asked that the final regulations clarify that the full amount of consideration allocable to the reinsured contracts is currently deductible under section 848(g) when the provisions of section 848 apply to an indemnity reinsurance transaction that occurs as part of a section 1060 acquisition of an insurance business." T.D. 9257 (April 10, 2006).

[3] Treas. Reg. § 1.1060-1(b)(9) states that, "The mere reinsurance of insurance contracts by an insurance company is not an applicable asset acquisition, even if it enables the reinsurer to establish a customer relationship with the owners of the reinsured contracts. However, a transfer of an insurance business is an applicable asset acquisition if the purchaser acquires significant business assets, in addition to insurance contracts, to which goodwill and going concern value could attach. For rules regarding the treatment of an applicable asset acquisition of an insurance business, see paragraph (c)(5) of this section."

[4] The CCA includes a footnote which states that the IRS position is that a retrocession agreement is treated as reinsurance citing Rev. Rul. 2008-15, 2008-1 C.B. 633, but noting the contrary conclusion in *Validus Reinsurance, Ltd. v. U.S.*, 19 F. Supp. 3d 225 (D.D.C. 2014) 2014-1 U.S. Tax Cas. (CCH) P70 325.

[5] The 1993 legislative history to section 197(f)(5) states as follows: The bill applies to any insurance contract that is acquired from another person through an *assumption reinsurance transaction (but not through an indemnity reinsurance transaction).* The amount taken into account as the adjusted basis of such a section 197 intangible, however, is to equal the excess of (1) the amount paid or incurred by the acquirer/reinsurer under *the assumption reinsurance transaction,* over (2) the amount of the specified policy acquisition expenses (as determined under section 848 of the Code) that is attributable to premiums received under *the assumption reinsurance transaction.* The amount of the specified policy acquisition expenses of an insurance company that is attributable to premiums received under an *assumption reinsurance transaction* is to be amortized over the period specified in section 848 of the Code. H.R. Rep. No. 103-213, at 687-88 (1993) (Conf. Rep.) *Assumption reinsurance* as defined in the legislative history is, "An assumption reinsurance transaction is an arrangement whereby one insurance company (the reinsurer) becomes solely liable to policyholders on contracts transferred by another insurance company (the ceding company). In addition, for purposes of the bill, an *assumption reinsurance transaction* is to include any acquisition of an insurance contract that is treated as occurring by reason of an election under section 338 of the Code." (Emphasis added.) H.R. Rep. No. 103-213, at 974 n. 125 (1993) (Conf. Rep).

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TWO PLRs PROVIDE SOME CLARITY ON SECTION 351 AND INDEMNITY REINSURANCE

By Lori J. Jones

Twenty years after the Internal Revenue Service (IRS) changed its position on the application of section 351 to assumption reinsurance transactions in Rev. Rul. 94-45, 1994-2 C.B. 39, through the issuance of two private letter rulings, we have some clarity on the corollary question of whether section 351 can also apply to indemnity reinsurance transactions even if novations are not expected as part of the overall transaction. The bottom line is that, if the indemnity reinsurance transaction is of a permanent nature, the IRS has concluded that section 351 can apply so that the ceding commission is not subject to tax pursuant to subchapter L (assuming all of the other section 351 requirements are satisfied). However, if the indemnity reinsurance agreement permits recapture by the ceding company or includes profit sharing provisions, the principles of subchapter L will apply to determine the proper tax treatment of the arm's length reinsurance portion of the transaction.

Section 351 provides that no gain or loss is recognized if property is transferred to a corporation by one or more persons solely in exchange for stock and immediately after the exchange such person(s) are in control of the corporation. In Rev. Rul. 94-45, the IRS held that the transfer of assets to a subsidiary which included the transfer of the insurance business via assumption reinsurance was tax-free under section 351. In that case, the ceding company was not subject to tax on the transfer of the insurance in force which was included in the value of the stock received in the exchange. If the reinsurance portion of the transfer is carved out of the section 351 transaction and treated as a taxable transaction, the results can be very different (e.g., increases/decreases in tax reserves, DAC, etc.)

PLR 201506008

In February, the IRS released PLR 201506008 (Oct. 21, 2014), which applied section 351 to an indemnity reinsurance transaction that the IRS stated was anticipated to result in a permanent transfer. (The ruling initially had been submitted to the IRS in June 2012, and, therefore, was not subject to the restrictions on section 351 rulings initially imposed by the Corporate Division in Rev. Proc. 2013-32, 2013-28 I.R.B. 55.) The proposed transaction involved the transfer of assets to a newly acquired dormant shell insurance company (Corporation C). Corporation C will be owned by newly formed Partnership B