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).

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

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(an LLC), which will in turn be owned by Partnership A (also an LLC). Partnership A also owns Corporation A, an insurance company for federal income tax purposes that operates as a direct writer and reinsurer of dental, life and health insurance contracts in most states. Partnership A was formed to provide a joint venture for Branded Insurers and their subsidiaries and to combine certain components of their dental, life and health business.

In the transaction, Partnership A will form Partnership B and Partnership B will acquire the stock of Corporation C. Partnership A will then contribute cash, and Corporation A and New Investors (who will acquire an interest in Partnership A) will contribute a certain percentage of their Specified Line of Business, to Corporation C solely in exchange for stock. Specifically, the contribution by Corporation A and New Investors will include insurance in force via reinsurance contracts, and a contract transferring the rights to perform administrative services for the business currently managed by New Investors (New ASC). Also in exchange for stock, Corporation A and the New Investors will contribute all existing unpaid Specified Line of Business liabilities (i.e., claims and IBNR liabilities) and related assets. The transferred assets will include cash, investment assets, and premium receivables, as well as the right to then future results of the future insurance policies for existing and future customers of Corporation A and New Investors. Corporation A also will transfer employees to Corporation C to perform certain functions relating to the business. After the contributions and pursuant to a pre-existing binding plan, Partnership A, Corporation A, and New Investors will contribute their Corporation C stock to Partnership B in exchange for Partnership B units.

The PLR also states that the transfer of the Specified Line of Business will be effected by a "100 percent coinsurance agreement written on an indemnity basis, with automatic reinsurance on new policies directly written on a going forward basis." The PLR specifically states:

> The reinsurance agreement will only be in exchange for a transfer of Corporation C shares, which represent a long-term continuing interest in Corporation C. There will be no experience rated refunds or profit sharing provisions to the reinsurance agreement. Should Corporation A or New Investors decide to withdraw from the joint venture, they would be required to purchase the Specified Line of Business it contributed back from Corporation C at fair market value including a gross up for taxes. **As a result, it is anticipated that the transfer under the reinsurance agreement will be permanent.** (Emphasis added.)

The New Investors will retain the actual subscriber, provider and underlying administrative services contracts and operate on a fronting basis via the indemnity reinsurance. It is also anticipated that Corporation C will operate via a transitional services agreement with New Investors until Corporation C has the infrastructure to manage the administration of the insurance business.

The IRS concluded that the transfer of assets by the Corporation C shareholders, including reinsurance contracts and new ASC, in exchange for Corporation C stock, constitutes a transfer of property to a controlled corporation meeting the requirements of section 351. Consequently, the IRS ruled that no gain or loss will be recognized by the shareholders on the transfer of the assets, including the Specified Line of Business, in exchange for stock. The IRS did not cite Rev. Rul. 94-45 as support for their conclusions.[2] It did require several typical representations from the taxpayer, including a representation that a portion of the fair market value of the stock to be issued is allocable to the value of the insurance in force and that Corporation C would be solvent immediately after the contributions. Similarly, the taxpayer represented that the total fair market value of the transferred assets will exceed the amount of any liabilities assumed (within the meaning of section 357(d) and taking into account the application of Rev. Rul. 80-323, 1980-2 C.B. 124) by Corporation C in connection with the exchange. (Rev. Rul. 80-323 holds that each partnership interest exchanged for Newco stock will be transferred subject to its share of partnership liabilities and gain will be recognized to the extent that each partner's share exceeds the adjusted basis of the interest transferred.) Most other representations were those required by Rev. Proc. 83-59, 1983-2 C.B. 575, which are/were applicable to section 351 transactions in general.

PLR 201511015

The IRS reached a different conclusion in PLR 201511015 (Nov. 14, 2014), where it held that the tax treatment of the transfer of assets and liabilities in the arm's-length reinsurance portion of a proposed transaction would be determined in accordance with the provisions of subchapter L applicable to indemnity reinsurance. (By contrast to PLR 201506008, this PLR was subject to the restrictions in Rev. Proc. 2013-32, *supra.*) The IRS also stated that the application of subchapter

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L to the reinsurance portion did not preclude the transfer of other assets in excess of the arm's-length reinsurance portion of the proposed transaction from qualifying under section 351. Thus, the IRS appeared to take the same approach here that it took in PLR 201006002 (Nov. 6, 2009) (where the arm's-length transfer of assets and liabilities in an indemnity reinsurance transaction were not subject to section 351, but the transfer of additional assets did qualify for section 351 treatment).

The proposed transaction in PLR 201511015 involves a Parent corporation that was the common parent of a life/nonlife consolidated return which includes LifeCo, a life insurance company for federal income tax purposes. LifeCo had previously demutualized and became a stock company now owned indirectly by Parent. Certain LifeCo policies in force at the time of its demutualization became a closed block of contracts entitled to receive policyholder dividends and LifeCo designated certain assets to support the regulatory closed block of policies (the RCB). The designated RCB assets are not kept in an account separate from LifeCo's other assets.

In the proposed transaction, LifeCo and Sub will enter into a Reinsurance Agreement. Sub will either be a newly formed corporation of LifeCo or an existing wholly owned corporation of LifeCo that is part of the life insurance company subgroup of the Parent consolidated group. LifeCo will transfer capital and surplus as well as assets and liabilities related to the RCB to Sub. It is represented that the fair market value of the assets that will be transferred to Sub will exceed the amount of assets that LifeCo would be required to pay in an arm's-length indemnity reinsurance transaction. The reinsurance transaction is described as follows:

> Pursuant to the Agreement, LifeCo will cede and Sub will assume certain specified liabilities. LifeCo will transfer approximately d percent, which is less than 100 percent, of the insurance risk on the RCB business to Sub by conventional coinsurance on the Effective Date. **Moreover, the Agreement provides LifeCo with recapture rights. At any time, LifeCo may elect to recapture, in full or in part, the reinsurance coverage provided by the Sub. If LifeCo elects to exercise such rights, the Sub is obligated to return any remaining RCB assets to LifeCo.** (Emphasis added.)

Key Differences

It is this last emphasized language in PLR 201511015 that provides a stark contrast to the facts stated in PLR 201506008, and which likely resulted in a different conclusion. Another factual difference is that PLR 201506008 did not involve a transaction between two members of the same consolidated group (as was the case in PLR 201511015). No analysis is provided in either PLR, but the key difference appears to be that in order for the transfer of assets and liabilities in an indemnity reinsurance transaction to qualify under section 351, the transfer must be "permanent." This conclusion is consistent with the IRS view that there is no transfer of intangible property unless all substantial rights in the property are transferred by the transferor corporation. See, e.g., Rev. Rul. 69-156, 1969-1 C.B. 101.[3] The conclusion is also consistent with Treas. Reg. section 1.197-2(g)(5)(iii), which provides guidance on the loss disallowance rule upon a disposition of an insurance contract acquired in an assumption reinsurance transaction. The regulation provides that the loss may be taken as a result of an indemnity reinsurance transaction, "provided that sufficient economic rights relating to the reinsured contracts are transferred to the reinsurer." Treas. Reg. section 1.197-2(g)(5)(iii)(A). The regulation also states that:

> However, the ceding company is not permitted to recover basis in an indemnity reinsurance transaction if it has a right to experience refunds reflecting a significant portion of the future profits on the reinsured contracts … through the exercise of a recapture provision. In addition, the ceding company is not permitted to recover basis in an indemnity reinsurance transaction if the reinsurer assumes only a limited portion of the ceding company's risk relating to the reinsured contracts (excess loss reinsurance).

In PLR 201506008, the taxpayer represented that there will be no experience rated refunds or profit sharing provisions to the reinsurance agreement and that a fair market value purchase price (including a gross up for taxes) would be required should the investors seek to repurchase the transferred business. In contrast, in PLR 201511015, the indemnity reinsurance agreement will provide the ceding company with recapture rights. It is not clear whether the IRS conclusion in PLR 201511015 was also based on the fact that less than 100 percent of the risk was transferred. Such a conclusion might be consistent with the last sentence in Treas. Reg. section 1.197-2(g)(5)(iii)(A)(2), i.e., that the reinsurer assumed only a limited portion of the risk.

Conclusion

The PLRs provide helpful guidance to determine when certain indemnity reinsurance transactions qualify for section 351 treatment. Importantly, however, the PLRs do not address all of the respective corollary consequences of section 351 treatment (or lack thereof) and do not provide guidance as to when a permanent transaction is effected in all situations. In any case, the guidance is welcome. ◂

END NOTES

[1] In Rev. Rul. 94-45, 1994-2 C.B. 39, the IRS revoked Rev. Rul. 75-382, 1975-2 C.B. 121, which held that section 351 did not apply to the transfer of cash and other assets by a foreign mutual life insurance company to a newly formed domestic life insurance company for all of its stock followed by an assumption reinsurance agreement. Since then, there have been numerous PLRs where the IRS held that section 351 applied to an indemnity reinsurance transaction as long as novations were anticipated as part of the overall transaction. *See, e.g.*, PLR 201232030 (May 10, 2012); PLR 200737012 (June 14, 2007); PLR 200447004 (July 27; 2004), PLR 200109039 (Dec. 4, 2000); PLR 200017002 (May 19, 1999); PLR 9752059 (Sept. 30, 1997); and PLR 9738031 (June 24, 1997). *See also* CCA 201501011 (Sept. 4, 2014), where the IRS took a broad view of assumption reinsurance for purposes of determining whether a ceding commission was subject to capitalization under section 197(f)(5).

[2] Nor did the IRS address the specific consequences of the section 351 transaction with respect to the transfer of assets and liabilities under subchapter L and section 848 (DAC).

[3] *See also E.I. DuPont de Nemours & Co., v. U.S.*, 471 F.2d 1211, 1219 (Cl. Ct. because prior to 1992), where the court agreed with the taxpayer that section 351 applied despite the absence of a sale or exchange, because "although the rights granted were not all the rights under the patents, they were perpetual, irrevocable, and quite substantial in value."

THE OECD'S BASE EROSION AND PROFIT SHIFTING ACTION PLAN: SHOULD INSURANCE COMPANIES CARE?

By David A. Golden

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Base Erosion and Profit Shifting Project

In February 2013, the Organisation for Economic Co-operation and Development (OECD) released its highly anticipated report on tax base erosion and profit shifting (BEPS).[1] The report was prompted by the perception of certain member countries that international tax rules have fallen behind rapidly changing international business practices, thereby allowing inappropriate BEPS. The BEPS Report was followed in July 2013 by the OECD's release of its action plan for addressing what it saw as gaps in the international tax system due to varying domestic tax regimes, which could lead to BEPS.[2] The BEPS Action Plan enumerates 15 areas of international tax law, practice and procedure for additional focus. These areas range from the tax challenges of the digital economy to developing more effective treaty amendment and dispute resolution processes. Of particular importance to insurance companies are Action 4, Interest Deductions and Other Financial Payments, and Action 13, Guidance on the Implementation of Transfer Pricing Documentation and Country-by-Country Reporting.[3]

Action 4

The OECD's discussion draft on Action 4 reiterates the concern of certain governments that multinational companies can erode their local country tax bases through excessive interest deductions.[4] The draft states that some entities in a multinational group may be excessively leveraged, and parent companies may borrow to invest in assets that generate income that is deferred or exempt for tax purposes. The Action 4 Discussion Draft expresses the OECD view that current local country limitations on interest expense deductions have not been entirely effective in addressing these issues. The draft further states that a consistent approach for rules on the deduction of interest expense would allow multinationals to plan their capital structures with greater confidence (as the risk of unilateral law changes would be minimized), reduce the risk of double taxation (e.g., situations where the creditor is taxed on interest income but the obligor is denied an interest expense deduction), and make it possible to introduce group-wide systems and processes to generate the information required to implement the limitations.

In order to address these concerns, the draft sets forth several alternative approaches to limiting deductions for interest expense. The principal approaches discussed are (1) a group-wide rule, which would limit a company's net interest deductions to a proportion of the group's actual net third-party interest expense; (2) a fixed ratios rule, which would limit a company's interest deductions to an amount determined by applying a fixed benchmark ratio to an entity's earnings, assets or equity; and (3) certain combinations of these two approaches. The Action 4 Discussion Draft also discusses the use of more targeted approaches. It identifies benefits and drawbacks of the approaches considered, as well as key questions raised by each approach.

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