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memorandum

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subject: Life Reinsurance Acquisition

This Chief Counsel Advice responds to your request for assistance. This advice may not be used or cited as precedent.

LEGEND

TAXPAYER =

SELLER =

DATE1 =

DATE2 =

DATE3 =

DATE4 =

Tax Year1 =

Tax Year2 =

#1 =

$U =

$V =

$W =

$X =

$Y =

TAXPAYER RESPONSE =

ISSUE

In a § 1060 acquisition in which TAXPAYER acquires life reinsurance contracts pursuant to a purported indemnity retrocession agreement, whether TAXPAYER may take an immediate deduction for the excess of the ceding commission over the § 848 DAC amount.

CONCLUSION

In a § 1060 acquisition in which the TAXPAYER acquires life reinsurance contracts pursuant to a purported indemnity retrocession agreement, TAXPAYER does not get an immediate deduction for the excess of the ceding commission over the § 848 DAC amount and must amortize it under § 197.

FACTS

TAXPAYER is under audit for Tax Year1 and Tax Year2.

Pursuant to a DATE1 Master Asset Purchase Agreement (AGREEMENT), TAXPAYER purchased from SELLER certain assets used in SELLER's life reinsurance business, including a workforce in place and fixed assets (equipment and furniture, computers, and phones), and the parties entered a retrocession[1] agreement for a specified number of SELLER's life reinsurance contracts.

Under the AGREEMENT, SELLER transferred and TAXPAYER assumed "assumed liabilities". Assumed liabilities include, among other items, the sum of all reserves and liabilities required to be maintained with respect to the assumed reinsurance or

[1] AGREEMENT is a retrocession contract (reinsurance of reinsurance). However, this memo refers to the arrangement between TAXPAYER and SELLER as "reinsurance".

retrocession agreements.[2] SELLER also paid TAXPAYER all premiums, payments, fees or other consideration or amounts due to SELLER under the Life Reinsurance Agreements.[3]

Although the AGREEMENT RECITAL[4] states that TAXPAYER wishes to assume this portion of SELLER's business on a 100% coinsurance indemnity basis, it provides that SELLER will enter an Assumption Agreement,[5] that SELLER will use reasonable efforts to assign all of its rights and obligations under the reinsurance agreements to ensure TAXPAYER was entitled to enforce such treaties against the reinsurers in its own name,[6] and that TAXPAYER and SELLER will use commercially reasonable efforts to ensure that TAXPAYER assumed, on a novation basis, each of the life reinsurance agreements.[7]

Finally, an "Entire Agreement" provision states that the AGREEMENT (including the Ancillary Agreements – e.g., the and the), other agreements contemplated, and the Exhibits [including Exhibit F, and Schedules [8]

By DATE2, TAXPAYER and SELLER obtained novations for #1 percent of retroceded contracts. By DATE3, they had novations for all of the contracts.

TAXPAYER states that the transaction is a § 1060 applicable asset acquisition.[9]

For statutory accounting purposes, TAXPAYER treated the transaction as indemnity reinsurance under SSAP 61, assumed $U of net aggregate reserves for life contracts, and recognized an initial ceding commission of $V. For federal income tax purposes, TAXPAYER treated $W as ceding commissions – capitalizing $X as § 848 specified policy acquisition expenses and deducting the remaining $Y in Tax Year 1.

Exam posits that the ceding commission is a § 197 intangible asset requiring TAXPAYER to amortize $Y over 15 years.

LAW AND ANALYSIS

ASSUMPTION AND INDEMNITY REINSURANCE

"The question of whether the language of an agreement is ambiguous is a question of law." Once a finding of ambiguity is made, interpretation of the contract will generally

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9 TAXPAYER RESPONSE - Confirmation of Facts on Seller Acquisition BUYER YEAR ENDED DECEMBER 31, TAX YEAR1.

become a question of fact for the jury. *United States v. Donovan*, 348 F.3d 509, 512 (6th Cir. 2003).

Insurers may reinsure their obligations to their policyholders by entering an assumption or indemnity reinsurance contract.[10]

Section 1.809-5(a)(7)(ii) defines assumption reinsurance as "an arrangement whereby another person (the reinsurer) becomes solely liable to the policyholders on the contracts transferred by (the ceding company). Such term does not include indemnity reinsurance or reinsurance ceded."

The United States Supreme Court described assumption and indemnity reinsurance arrangements.

> In the case of assumption reinsurance, the reinsurer steps into the shoes of the ceding company with respect to the reinsured policy, assuming all its liabilities and its responsibility to maintain required reserves against potential claims. The assumption reinsurer thereafter receives all premiums directly and becomes directly liable to the holders of the policies it has reinsured.
>
> In indemnity reinsurance…, it is the ceding company that remains directly liable to its policyholders, and that continues to pay claims and collect premiums. The indemnity reinsurer assumes no direct liability to policyholders. Instead, it agrees to indemnify, or reimburse, the ceding company for a specified percentage of the claims and expenses attributable to the risks that have been reinsured, and the ceding company turns over to it a like percentage of the premiums generated by the reinsurance of those risks.

Colonial Am. Life Ins. Co. v. Commissioner, 491 U.S. 244, 247 (1989).

However, critiquing the Court's decision in Colonial Am. Life Ins. Co., *Holmes' Appleman on Insurance 2d*, states:

> With all due respect to the Supreme Court, true reinsurance, in the eyes of insurance lawyers involves… the indemnity taken by an insurance company to secure itself against an excessive loss upon a certain risk, not inuring to the benefit of the insured. When the risk itself is shifted to a company other than the original insurer, and the second company assumes direct liability to the policyholder, it is a substitution of risk, rather than true reinsurance.

[10] Service position is that a retrocession agreement is treated as reinsurance. See, Rev. Rul. 2008-15, 2008-1 C.B. 633 (premium paid on a retrocession contract between two foreign reinsurance companies is subject to the one-percent excise tax imposed by § 4371(3)). But see, *Validus Reinsurance, Ltd. v. United States* 2014-1 U.S. Tax Cas. (CCH) P70, 325 (D.D.C. 2014). (Section 4371 does not impose an excise tax on retrocession insurance transactions; insurer receives a refund of the excise paid).

"In the parlance of the insurance industry a 'reinsurance and assumption agreement' is the contractual vehicle by which a book of primary insurance business is moved from one primary insurer to another primary insurer. In fact, this transaction is a novation rather than a reinsurance transaction…. Sometimes insurers make a corporate decision to exit a line of business and (reinsurance and assumption) is one of the faster ways of doing so."[11]

The Restatement, Second Contracts (RSC)… applies to contracts in general including reinsurance contracts.[12]

In certain circumstances, the RSC precludes an obligor from delegating the performance of his duty to another and, unless the obligee agrees otherwise, neither delegation of performance nor the contract between the obligor and the person to whom delegated relieves the obligor of its duty or liability.[13] However, if the original contract provides for *potential* novation, then the original obligor can discharge its liability (emphasis added).[14]

MERE REINSURANCE - REINSURER'S TAX TREATMENT OF CEDING COMMISSION (SERVICES MODEL)

The mere reinsurance of insurance contracts by an insurance company is not a § 1060 acquisition, even if it enables the reinsurer to establish a customer relationship with the owners of the reinsured contracts.[15]

Described by the Service as the "services model" (i.e., the seller/ceding company is treated as paying a premium to the buyer/reinsurer to assume the risk on its insurance contracts),[16] mere reinsurance is subject to the reinsurance rules of Treas. Reg. § 1.817-4(d) because the total consideration paid for the transfer of insurance contracts and assumption of related liabilities is known and it is not part of a larger acquisitive transaction.[17] The reinsurer's ceding commission for the reinsured contracts equals the liabilities assumed by the reinsurer as a result of the reinsurance transaction minus the net value of the tangible and intangible assets acquired (other than any value of the reinsured policies). (Treas. Reg. § 1.817-4(d)(2).)

How the reinsurer treats the ceding commission for federal income tax purposes depends on whether (1) the parties entered an assumption or indemnity reinsurance

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[11] Robert M. Hall, *REINSURANCE AND ASSUMPTION AGREEMENTS: HOW DOES THE NOVATION TAKE PLACE?*, Piper Marbury Rudnick & Wolfe (2001) *at* http://www.robertmhall.com/articles/Reins_AssumpArt.htm.

[12] *Ibid;* See also, Larry P. Schiffer, *Adventures in Contract Wording: The Effect of Ambiguous Reinsurance Contract Language*, Squire Patton Boggs (US) LLP (September 2000) *at* http://www.irmi.com/expert/articles/2000/schiffer09.aspx. ("The law of contracts applies to reinsurance contracts with equal force.")

[13] Restat 2d of Contracts, § 318(1) – (3).

[14] *Ibid*.

[15] Treas. Reg. § 1.1060-1(b)(9).

[16] Preamble, T.D. 9257, 2006-1 C.B. 821 (April 10, 2006).

[17] Preamble, Prop. Treas. Reg. § 1.1060-1, 67 Fed. Reg. 10640 (March 8, 2002).

agreement and (2) the underlying contracts are specified insurance contracts under § 848.

Assumption reinsurance contracts are § 197 intangibles. (§ 197(d)(2).) In general, indemnity reinsurance contracts are not.[18] However, the legislative history provides that, for purposes of § 197, an assumption reinsurance transaction includes any acquisition of an insurance contract that is treated as occurring by reasons of an election under § 338 thus expressing Congressional intent that an indemnity reinsurance acquired in a § 338 asset acquisition could be a § 197 intangible.[19]

Consistent with this legislative history, the § 197 regulations provide that the transfer of insurance or annuity contracts and the assumption of related liabilities deemed to occur by reason of a § 338 election for a target insurance company is treated as an assumption reinsurance transaction. 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.[20]

The reinsurer in an assumption reinsurance arrangement amortizes the ceding commission over 15 years.[21] The reinsurer in an indemnity reinsurance contract deducts the ceding commission.[22]

Insurers issuing specified insurance contracts capitalize specified policy acquisition expenses (DAC). (§ 848(a)).

The DAC amount (net premium multiplied by the capitalization rate for that type not in excess insurance company's general deduction) serves as a proxy for the actual cost, including the ceding commission, the reinsurer incurred to acquire the insurance contract. (§ 848(c).)

A specified insurance contract (DAC contract) is any life insurance, annuity, or noncancellable accident and health insurance contract (or any combination thereof). (§ 848(e)(1).)

A reinsurance contract is treated in the same manner as the reinsured contract without distinguishing between an assumption and an indemnity reinsurance arrangement. (§ 848(e)(5).)

Section 848(g) provides:

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[18] See H.R. Conf. Rep. No. 213, 103rd. Cong. 1st Sess. 687-688. Although the legislative history does not state why Congress excluded indemnity reinsurance from the provisions of § 197, one commentator suggests that it is because goodwill does not attach to indemnity reinsurance contracts. M Douglass, Tangible Results for Intangible Assets: An Analysis of Section 197, The Tax Lawyer (vol. 47 No. 3 Spring 1994) at 733 nt.126.
[19] S. Rep. No. 213, 103d Cong. 1st Sess. 675, 687 (1993).
[20] § 1.197-2(g)(5)(i).
[21] § 197(f)(5) and Treas. Reg. § 1.197-2(f)(1).
[22] See, *Colonial Am. Life Ins. Co.* and § 848(g).

> Nothing in any provision of law (other than this section or section 197) shall require the capitalization of any ceding commission incurred on or after September 30, 1990, under any contract which reinsures a specified insurance contract.

An assumption reinsurer of a DAC contract capitalizes, straight-line over a 120-month period, the ceding commission it paid for assumption reinsurance of DAC contracts. It then amortizes, over fifteen years, the excess of the ceding commission over the DAC amount.[23]

An indemnity reinsurer of a DAC contract capitalizes the ceding commission over the 120-month period then deducts the excess of the ceding commission over the DAC amount. (§§ 848(a) and (g).)

§ 1060 APPLICABLE ASSET ACQUISTION THAT INCLUDES INSURANCE CONTRACTS – REINSURER'S TAX TREATMENT OF CEDING COMMISSION (ASSET PURCHASE MODEL)

In contrast to mere reinsurance, a transfer of an insurance business is a § 1060 acquisition if the TAXPAYER acquires significant business assets, in addition to insurance contracts, to which goodwill and going concern value could attach.[24]

To reflect what the Service described as an "asset purchase model" (i.e., buyer acquires assets for a stated consideration),[25] a § 1060 acquisition of a trade or business is subject to the regulations applicable to certain § 338 deemed asset sales.[26] Therefore, like § 338 transaction, § 1060 acquisitions are hypothetical assumption reinsurance transactions.[27] As assumption reinsurance transactions, they are subject to the reinsurance rules of Treas. Reg. § 1.817-4. However, these reinsurers use the residual method, not the reserve method of Treas. Reg. § 1.817-4(d)(2), to determine their basis in the assets (including the ceding commission).[28]

The residual method allocates the total purchase price among all the assets acquired (including the ceding commission and assumed liabilities) based on asset class. Both indemnity and assumption reinsurance contracts are treated as Class VI assets[29] even if the acquisition is effected in whole or in part through indemnity reinsurance rather than assumption reinsurance, and, for the insurer or reinsurer, an insurance contract

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[23] §§ 848(a) and 197(f)(5) and Treas. Reg. § 1.197-2(g)(5)(i).
[24] Treas. Reg. § 1.1060-1(b)(9).
[25] *See Supra*, note 16.
[26] Treas. Reg. §§ 1.338-6, 1.338-7, and 1.338-11(a) – (d). See, Treas. Reg. § 1.197-2(e)(5). A qualified stock purchase that is treated as a purchase of assets under § 338 is treated as a transaction involving the acquisition of assets constituting a trade or business only if the direct acquisition of the assets of the corporation would have been treated as the acquisition of assets constituting a trade or business or a substantial portion thereof.
[27] Treas. Reg. § 1.338-11(c).
[28] Treas. Reg. §§ 1.338-11(c) and 1.1060-1(a) and (c)(5).
[29] A Class VI asset is "all § 197 intangibles, except goodwill and going concern value." Treas. Reg. § 1.338-6(b)(2)(vi)

(including an annuity or reinsurance contract) is a Class VI asset regardless of whether it is a section 197 intangible.[30]

For purposes of allocating the total purchase price, the fair market value of a specific insurance, reinsurance or annuity contract or group of insurance, reinsurance or annuity contracts (insurance contracts) is the amount of the ceding commission a willing reinsurer would pay a willing ceding company in an arm's length transaction for the reinsurance of the contracts if the gross reinsurance premium for the contracts were equal to (seller's) reserves for the contracts.[31]

Treas. Reg. § 1.338-11(a) provides:

> In the case of a conflict between the provisions of this and other provisions of the Internal Revenue Code or regulations, the rules set forth in this section determine the Federal income tax treatment of the parties and the transaction when a section 338 election is made for an acquired insurance company.

ANALYSIS

TAXPAYER determined that the AGREEMENT was an indemnity retrocession contract in Tax Year1 because it did not create any legal relationship between TAXPAYER and any person other than SELLER. SELLER remained liable to the parties to the underlying reinsurance contracts because none of the novations were complete before DATE4.

The AGREEMENT RECITAL supports TAXPAYER's position that the retrocession is on a 100 percent indemnity co-insurance basis. However, the contract as a whole includes the language of an assumption reinsurance arrangement and there are sufficient facts to conclude that AGREEMENT is an assumption retrocession contract. They include:

- The "Entire Agreement" provision incorporates, among other ancillary agreements, Assumption and Novation Agreements;
- Under the RCS, the potential novation can discharge SELLERS liability;
- AGREEMENT transfers the sum of all reserves and liabilities required to be maintained with respect to the assumed reinsurance or retrocession agreements and the SELLER agreed to pay TAXPAYER all premiums, payments, fees or other consideration or amounts due to SELLER under the Life Reinsurance Agreements; and
- Entering a § 1060 applicable asset acquisition of a trade or business, shows SELLER's intent to sell and exit, and TAXPAYERS intent to acquire, the life reinsurance business.

[30] Treas. Reg. §§ 1.1060-1(a)(1) and 1.1060-1(c)(5).
[31] Treas. Reg. §§ 1.338-11(b)(2) and (c)(3).

To explain its tax treatment of the ceding commission, TAXPAYER stated that the indemnity retroceded life insurance contracts are § 848 specified insurance contracts so it amortized the ceding commission up to the DAC amount. With respect to the remainder, because the indemnity retrocession contract with SELLER is not a § 197 intangible, § 848(g) allows an immediate deduction for the ceding commission in excess of the DAC amount. However, TAXPAYER's analysis is incomplete.

TAXPAYER does not address why the regulations under §§ 1060, 338, and 197 do not apply to this transaction. 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 rules describing the residual method are clear that an indemnity reinsurance contract is a Class VI, § 197 intangible. They are also clear that they treat § 338 and § 1060 acquisitions as deemed assumption reinsurance arrangements. In general, the ceding commission on assumption reinsurance contracts are capitalized over ten years under § 848 then amortized over fifteen under § 197.

After it issued the proposed regulations, the Service received comments asking that the final § 338 regulations clarify that § 197 amortization does not apply to deemed assumption reinsurance arrangements allowing an indemnity reinsurer an immediate deduction of the ceding commission under § 848(g). The final regulations do not provide this immediate deduction and allowing it would be inconsistent with Congressional intent.[32]

The § 338 regulations treat the deemed sale of insurance contracts as assumption reinsurance transactions for federal income tax purposes. These regulations apply to § 1060 acquisitions of insurance companies. Accordingly, a § 1060 acquisition is likewise treated as an assumption reinsurance transaction. Under Treas. Reg. § 1.338-11(a)(1), these provisions take precedence over all others in the Code and regulations. In order for § 1.338-11(a)(1) to be consistent with § 848(g) (that no provision of law other than §§ 848 and 197 shall require the capitalization of any ceding commission on any reinsured specified insurance contract), the hypothetical assumption reinsurance contract would also have to be treated as a § 197 intangible. As a § 197 intangible, any excess ceding commission over the DAC amount is amortized over fifteen years.[33]

TAXPAYER must capitalize, under § 848, the ceding commission it paid SELLER to acquire its life reinsurance business in a § 1060 acquisition and amortize, under § 197, the excess above the DAC amount.[34]

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[32] Supra, note 16.

[33] § 197 and Treas. Reg. §§ 1.197-2(g)(5) and 1.338-11(c)(4) EXAMPLE 1.

[34] But see, FSA 200144028 (November 2, 2001). In a transaction in which TAXPAYER acquired, through indemnity reinsurance, substantially all of the tangible and intangible assets associated with the SELLER's insurance business, the Service concluded that, under the proposed and temporary §§ 338 and 1060 regulations, TAXPAYER applies the § 338 residual allocation method, not the reserve method of Treas. Reg. § 1.817-4(d)(2), to determine its basis in the reinsurance ceding commission paid. However, although § 338 regulations treated asset acquisitions (and stock purchases treated as asset acquisitions) involving insurance

companies as assumption reinsurance transactions, the FSA does not address the application of this provision to the indemnity reinsurance contracts described. Also, it appears that the Service, without further analysis, accepted as fact that § 848(g) applied to allow the TAXPAYER an immediate deduction for the ceding commission paid.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

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Please call Sharon Y. Horn at 202-317-4426 if you have any further questions.