Client Update
IRS Counsel's Memorandum Challenges Deductibility of Ceding Commission for Indemnity Reinsurance Transaction

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The Internal Revenue Service ("IRS") Office of Chief Counsel has released a memorandum (the "CCA") concluding that a taxpayer was not entitled to a current deduction for the ceding commission paid under an indemnity retrocession treaty in connection with the acquisition of a life reinsurance business, but instead was required to amortize the ceding commission under rules applicable to intangible assets that are amortizable under section 197 of the Internal Revenue Code.[1]

The CCA seeks to interpret Treasury regulations relating to the acquisition of assets that constitute a trade or a business in a manner that would substantially expand the scope of section 197 – which by its terms is limited to insurance contracts that are acquired through assumption reinsurance transactions – to cover indemnity retrocession treaties executed in connection with the acquisition of an insurance or reinsurance business. The CCA's conclusion contradicts section 848(g), which says explicitly that nothing in any provision of law other than section 848 and section 197 (which does not apply to indemnity reinsurance transactions) shall require the capitalization of a ceding commission paid in connection with a reinsurance agreement that reinsures life, annuity and noncancellable accident and health insurance contracts.

The CCA also concludes that an undertaking to attempt a novation of reinsured contracts can transform an indemnity reinsurance transaction into an assumption reinsurance transaction for tax purposes. This conclusion raises questions under general tax principles and existing case law regarding "step transactions," and also suggests that in certain fact patterns the IRS may

[1] *CCA 201501011* (January 2, 2015).

challenge deductibility even if the reinsurance transaction is not part of the acquisition of a business.

THE CCA – FACTS

The CCA describes a transaction in which the taxpayer acquired a life reinsurance business by purchasing its workforce and other assets and entering into a retrocession agreement that passed to the taxpayer 100% of the reserves and liabilities, as well as premiums and other payments, associated with a number of life reinsurance contracts. The transaction was structured as an indemnity reinsurance transaction, under which the selling company remained directly liable to its underlying ceding companies (who continued to be party to reinsurance treaties with the seller), rather than an assumption reinsurance transaction, in which the acquiror would have become directly liable to the underlying cedents (whose contracts would in effect have been exchanged for acquiror contracts). The retrocession agreement included a covenant by the seller to use commercially reasonable efforts to subsequently novate the underlying reinsurance contracts to the taxpayer after the closing. At some point following the closing, the contracts were all novated, and at that point the taxpayer did become directly liable to the underlying ceding companies.

IRS COUNSEL'S ANALYSIS

Section 848(g) of the Internal Revenue Code provides that nothing in any provision of law (other than section 848 or section 197) shall require the capitalization of ceding commissions under contracts that reinsure life, annuity and noncancellable accident and health insurance contracts. Section 197 requires certain acquired business intangibles to be amortized over 15 years. The value of insurance contracts acquired in an assumption reinsurance transaction (including an assumption reinsurance that is deemed to occur as a result of a section 338 election) is treated as an intangible subject to section 197. However, the legislative history and regulations state that indemnity reinsurance contracts are not subject to section 197. Accordingly, the ceding commission paid by a reinsurer to the ceding company in an indemnity reinsurance transaction is generally deducted on a current basis to the extent it exceeds the so-called DAC amount calculated under section 848.

In the CCA, the IRS counsel challenged the deductibility of the ceding commission on two grounds. First, the IRS counsel concluded that, despite the fact that the transaction was structured as indemnity reinsurance, the passing of 100% of the benefits and burdens of the underlying reinsurance treaties, together with contract language requiring the purchaser and seller to use commercially reasonable efforts to novate the contracts after the closing, and the fact that the

contracts were all eventually novated, indicated that the retrocession was in substance an assumption reinsurance transaction.

Second, the IRS counsel took the position that, because the retrocession was a component of the acquisition of a trade or business, the ceding commission was not deductible whether or not the transaction was assumption reinsurance.

Under section 1060 of the Code, when a reinsurance contract is part of an acquisition of a trade or business, the consideration for the transaction is allocated among the acquired assets for tax purposes based on an allocation methodology that is set out in Treasury regulations under section 338. Section 338 treats the sale of a corporation's stock as a deemed sale of its assets and assumption of its liabilities if certain elections are made. When an election under section 338 is made with respect to the sale of stock of an insurance company, special rules in the section 338 regulations treat the target as having transferred its insurance contracts in an assumption reinsurance transaction as part of the deemed asset sale. Because the section 1060 regulations incorporate the methodology of the section 338 regulations, the CCA argues that these regulations do not simply provide a method for allocating purchase price, but override the normal operation of section 848(g) and require an indemnity reinsurance transaction subject to section 1060 to be treated as assumption reinsurance for all purposes, including the section 197 amortization requirement.

THE CCA CONTRADICTS EXISTING AUTHORITIES

The CCA's conclusion that an undertaking to attempt a novation can transform an indemnity reinsurance transaction into an assumption reinsurance transaction raises questions under general tax principles and existing case law regarding "step transactions."

While a ceding company may covenant to use its efforts to secure a novation, novation generally requires the consent of the policyholder (or ceding reinsurer) under each underlying insurance (or reinsurance) contract covered by the indemnity agreement or, in certain states, regulatory approval and negative consent by the underlying policyholders. The exact facts of the transaction that is the subject of the CCA are not known. Where the novation requires the consent of numerous third parties who are not controlled by the ceding company or reinsurer and will act in their own best interests, at the time the reinsurer pays the ceding commission for an indemnity reinsurance transaction, it cannot be certain that any future novation will occur. In these circumstances, it would inconsistent with general tax principles to step together the indemnity reinsurance transaction and any subsequent novation so as to treat the separate

transactions as a single assumption reinsurance transaction, and to treat the reinsuring company as having paid for an assumption that it may never get.

The CCA's position that the section 338 rules prevent ceding commissions from being currently deducted in any section 1060 transaction is also contrary to the relevant authorities.

Section 848(g) says explicitly that "nothing in any provision of law" other than section 848 and section 197 may require the capitalization of a ceding commission paid with respect to contracts covered by section 848. The application of Section 197 is limited to insurance contracts that are acquired through an assumption reinsurance transaction (or as a result of an assumption reinsurance transaction that is deemed to occur pursuant to a section 338 election). The IRS does not have the authority to override these specific statutory provisions in regulations under section 338 or 1060.

Moreover, the regulations under section 1060 do not support the view that the section 1060 rules governing allocation of consideration transform an indemnity reinsurance contract into assumption reinsurance for purposes of section 197. Treasury Regulation section 1.1060-1(c)(5) states that the principles of section 338 "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]. Thus, the regulations provide that indemnity reinsurance contracts in section 1060 transactions are subject to the allocation methodology in the Section 338 regulations even though they are not subject to section 197. Moreover, the Notice of Proposed Rulemaking that added Treasury Regulation 1.1060-1(c)(5), as well as section 197 and section 338 regulations governing reinsurance transactions, provided that "the rules in the proposed regulations under section 197 also apply to reinsurers of insurance businesses in transactions governed by section 1060 *if effected through assumption reinsurance*" [emphasis added]. Contrary to the analysis in the CCA, the section 1060 regulations simply do not provide that an indemnity reinsurance transaction that actually occurs in an applicable asset acquisition should be treated in the same manner as an asset sale that is deemed to occur as a result of a section 338 election.

IMPLICATIONS

The CCA's interpretation of the regulations is inconsistent with the language and legislative history of sections 197 and 848, as well as the regulations under

section 1060. However, the CCA suggests that the IRS may seek to challenge current deductions for ceding commissions paid in 100% indemnity reinsurance transactions where material assets relating to the underlying business are acquired. In addition, the CCA's suggestion that a covenant to attempt to novate may transform indemnity reinsurance into assumption reinsurance indicates that the IRS may challenge deductibility even if the reinsurance transaction is not part of a section 1060 applicable asset acquisition in certain fact patterns. At a minimum, the CCA, by introducing uncertainty into the tax treatment of ceding commissions paid in indemnity reinsurance transactions, may complicate the pricing of transactions that could come within the scope of the CCA.

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Please do not hesitate to contact us with any questions.