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Memorandum

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to:
Supervisory Internal Revenue Agent
LMSB

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subject:

This is in response to your request for our advice concerning I.R.C. § 845(b).

<u>LEGEND</u>

COMPANY A =

COMPANY B =

COMPANY C =

COMPANY D =

COMPANY E =

COMPANY F =

STATE Z =

COUNTRY Y =

YEAR 1 =

YEAR 2 =

YEAR 3 =

YEAR 4 =

YEAR 5 =

YEAR 6 =

YEAR 7 =

YEAR 8 =

AMOUNT M =

AMOUNT N =

AMOUNT O =

AMOUNT P =

AMOUNT Q =

AMOUNT R =

AMOUNT S =

AMOUNT T =

AMOUNT U =

AMOUNT V =

DATE 1 =

DATE 2 =

ISSUE

Whether the reinsurance transaction between should be disallowed pursuant to I.R.C. § 845(b)?

FACTS

COMPANY A owns one hundred percent of COMPANY B, a holding company. COMPANY B in turn owns one hundred percent of COMPANIES C and D. COMPANY C owns one hundred percent of COMPANY E while COMAPNY D owns one hundred percent of COMPANY F. (See Exhibit 1 for an organizational chart). As the bard[1] said, the world is a stage, and in this drama COMPANIES E and F are the primary players. COMPANY E is

COMPANY E is domiciled in the STATE of Z. It is licensed to do business in all 50 states. COMPANY F is domiciled offshore in COUNTRY Y. COMPANY F is a COUNTRY Y insurance company. Although COMPANY F is an offshore insurance company it has made an election under I.R.C. § 953(d) to be treated as a domestic corporation. As a result of making this election COMPANY F must treat any loss as a dual consolidated loss under I.R.C. § 1503(d). Therefore, COMPANY F's losses may not be used to reduce the taxable income of any other member of Company A's affiliated group for any tax year.

COMPANY F's only insurance business since year 1 has been insuring

In YEAR 1 COMPANY F reported a profit, but since that time this line of business has been unprofitable. In YEARS 2,3,4,5 and 6 COMPANY F averaged losses of approximately AMOUNT M per year. By YEAR 6 COMPANY F had built up net operating losses (NOLs) of some AMOUNT N. (See, Exhibit 2). By letter dated DATE 1 COMPANY E wrote to the Insurance Department in STATE Z to request permission to reinsure with COMPANY F a highly profitable block of business

Although the letter was written toward the end of YEAR 6, it requested that the reinsurance be effective retroactively back to DATE 2, at the beginning of Year 6. (See, Exhibit 3, COMPANY A's letter to STATE Z's insurance department dated DATE 1). As a result of the reinsurance transaction with COMPANY E, COMPANY F's fortunes changed considerably for YEARs 7 and 8. Instead of reporting losses as it had for the previous five years, COMPANY F reported taxable income (offset completely by carryforward NOLs) of AMOUNT O and AMOUNT P. (See. Exhibit 2).

There are many legitimate business reasons for entering into a reinsurance transaction including: (1) increasing underwriting capacity; (2) achieving economies of scale in managing risk; (3) obtaining surplus relief: (4) reducing exposure from one catastrophic event; (5) functioning as a business acquisition technique by allowing the reinsuring to acquire a block of business in a new line of business; and, (6) allowing the ceding company to divest itself of a line of business.[2] COMPANY A contends that the

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[1] Shakespeare, As You like It. "All the world's a stage; And all the men and women merely players… ."

[2] See, Barry R. Ostrager and Mary Kay Vyskocil, "Modern Reinsurance Law and

reinsurance transaction between COMPANIES E and F was entered into for legitimate business reasons, and was not motivated by tax considerations. More specifically it contends that

COMPANY A contends this transaction resulted in greater capital efficiency. The Service questions whether this reinsurance transaction would have been entered into absent the rapidly escalating NOLs for COMPANY F. The Service recognizes that this reinsurance transaction provided surplus relief in the amount of AMOUNT Q. However, since Company E had surplus in the amounts of AMOUNT R and AMOUNT S for YEARS 7 and 8 without the reinsurance transaction at issue, the Service does not believe that surplus relief was urgently needed, or a primary motive for the transaction. Although the motivations for entering into the transaction can be argued about, it is crystal clear that if this reinsurance transaction was not entered into COMPANY F's net operating loss would have increased by AMOUNT T by the end of YEAR 8. In addition, if the reinsurance transaction was not entered into COMPANY E would have paid tax on an additional AMOUNT U and AMOUNT V for YEARs 7 and 8, respectively. (See Exhibit 4).

ANALYSIS

Section 845 became part of the Code, and has remained substantially unchanged for nearly a quarter of a century. One might expect that regulation, ruling, or case law would have added significant flesh to the statutory skeleton by now, but alas one would be disappointed. There are no regulations, no revenue rulings, and only one significant case, Trans City Life Ins. v. Commissioner, 106 T.C. 274 (1996), nonacq., 1997-2 C.B. 1 and recommendation regarding acquiescence, AOD-1997-11, 1997 WL 695853 (I.R.S. AOD 1997).

Section 845(b) of the Code provides that if the Secretary determines that any reinsurance contract has a significant tax avoidance effect on any party to such contract, the Secretary may make proper adjustments with respect to the party to eliminate the tax avoidance effect, including treating the contract as terminated on December 31 of each year and reinstated on January 1 of the next year.

Section 845 of the Code was enacted as part of the comprehensive revision of the life insurance company tax provisions made by the Tax Reform Act of 1984 (1984 Act). Under a prior law provision, the Secretary had authority to allocate or recharacterize items relating to a reinsurance contract between related persons (as defined in section 1239(b) of the Code) if it determined that such action was necessary to reflect the proper source and character of taxable income of the parties (including any

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Practice", § 1.02, Glasser Legal Works, (2000); Donald A. McIsaac and David F. Babbel, "The World Bank Primer on Reinsurance", Policy Research Working Paper, 1512, The World Bank (1995); Joseph Sieverling and Scott Williamson, "The U.S. Reinsurance Market", in Reinsurance: Fundamentals and New Challenges (ed. Ruth Gastel), Insurance Information Institute (2004) 126).

item used in determining taxable investment income and gain from operations). See former section 818(g) of the Code, added by section 258(a) of the Tax Equity and Fiscal Responsibility Act of 1982, Pub.L. 97-248 (September 3, 1982) (effective for reinsurance agreements entered into after September 3, 1982). See also 1 S.Rept. No. 494, 97th Cong.2d Sess. 337 (1982); H.R.Conf.Rept. No. 760, 97th Cong.2d Sess. 641-42 (1982), 1982-2 C.B. 682-83 (Conference follows Senate amendment). Section 845 expanded the authority of the Secretary to make adjustments in reinsurance transactions by adopting an expanded definition of the term “related persons” and adding a provision covering agreements between unrelated parties.

The Conference Report accompanying enactment of this provision, H.R.Conf.Rep. No. 861, 98th Cong., 1st Sess. 1061 (1984), 1984-3 C.B. (Vol. 2) 315, (“Conference Report”) states that the operative standards for the exercise of the Secretary's adjustment authority under the related party rules of section 845(a) or the unrelated party rules of section 845(b) are objective tests of (1) whether adjustments are necessary to more properly reflect income, or (2) whether the reinsurance transaction has a significant tax avoidance effect. The Conference Report at 1062 also states that any transaction within the scope of the unrelated party rule (that is, any transaction with a significant tax avoidance effect) is within the scope of the related party rule but that transactions outside the unrelated party rule (that is, transactions without significant tax avoidance effect) may be subject to adjustment under the related party rule. 1984-3 C.B. (Vol. 2) 316.

The Conference Report further states that, for purposes of determining whether adjustments may be made in a reinsurance agreement, the motivation of the parties to the agreement is wholly irrelevant, viz., the fact that a transaction has a business purpose or was not entered into with tax avoidance or evasion as a principal purpose or is entered into at arm's length does not foreclose the Secretary making an adjustment in a reinsurance transaction. 1984-3 C.B. (Vol. 2) 316.

The Conference Report at 1063 refers to certain situations in which a tax avoidance effect may arise as well as to situations in which a tax avoidance effect will be considered “significant.”

[W]hether a reinsurance contract has a tax avoidance effect with respect to any party should be determined by reference to the effect (with respect to one or both parties) in the current year or any other year, after taking into account the time value of money. A tax avoidance effect may arise, for example, when the reinsurance contract artificially reduces a company's equity, changes the source or character of any item, defers taxation of income items, eliminates the “SRLY[3] taint” of a previous net operating loss, artificially transfers tax benefits between taxpayers in different brackets, or effectively extends a carryover period. A tax avoidance effect is significant if the

[3] In general, the taxable income of a consolidated group is determined by aggregating the income and losses of each member of the group. However, in certain situations the separate return limitation year (SRLY) rules limit the use of the losses by other members of the consolidated group.

transaction is designed so that the tax benefits enjoyed by one or both parties to the contract are disproportionate to the risk transferred between the parties. There is no significant tax avoidance effect for a reinsurer, however, merely because a tax reduction arises from a loss on the reinsurance contract for a particular year, if the loss experienced was not greater than if the reinsurer had written the allocable portion of the reinsured business directly.

1984-3 C.B. (Vol. 2) 316-17.

The Conference Report at 1063 states that in determining whether a reinsurance agreement between unrelated parties has a significant tax avoidance effect with respect to one or both parties, the Secretary should examine the economic substance of the transaction. The Report then refers to a number of factors that may be considered by the Secretary in determining whether a reinsurance agreement between unrelated parties has a significant tax avoidance effect, while noting that none of these factors alone will be determinative. These factors, described at pages 1063-64 of the Conference Report, include (i) the duration or age of the business reinsured; (ii) the character of the business reinsured; (iii) the structure for determining the potential profits of each of the parties and any experience rating formula; (iv) the duration of the reinsurance agreement between the parties; (v) the parties' rights to terminate the reinsurance agreement and the consequences of a termination; (vi) the relative tax positions or tax brackets of the parties; and (vii) the general financial situations of the parties. 1984-3 C.B. (Vol. 2) 317-18.

Taking into account the factors described above, the Conference Report describes certain kinds of reinsurance transactions which, pending the issuance of regulations, generally will not give rise to a significant tax avoidance effect requiring the exercise of the Secretary's adjustment authority. The Conference Report, at 1064, describes these “safe harbor” transactions as follows:

First, yearly renewable term reinsurance will not require adjustments to the parties, to the extent it requires only the payment of a premium for the annual risk and no sharing of expenses.

Second, coinsurance of annual renewable term life insurance will generally not require adjustments, because it requires the transfer of an annual risk premium and a sharing of expenses, but does not involve the transfer of long-term reserves.

Third, a coinsurance contract covering new business of the ceding company and which allocates expense and income items between the ceding company and the reinsurer in the same proportion as the allocation of the risk reinsured generally will not require adjustment by the Treasury. The same will be true with respect to the reinsurer for the coinsurance contract entered into to cover existing business, if the initial ceding commission is reasonable in reflecting the proper allocable share of past expenses of the ceding company and any premium that might be paid by the reinsurer to the ceding company that reflects anticipated profitability of the reinsured business.

1984-3 C.B. (Vol. 2) 318.

In Trans City Life Ins. v. Commissioner, supra, the Commissioner asserted that a reinsurance transaction that allowed the taxpayer to claim the small life insurance company deduction of section 808 had a significant tax avoidance effect under section 845(b). The Tax Court rejected the taxpayer's argument that the Commissioner could not assert the authority in section 845(b) in the absence of regulations. This turned out to be something of a Pyrrhic victory since the court ultimately held that the Commissioner abused his discretion in determining the reinsurance agreements had a significant tax avoidance effect. Thus, while Trans City Life Ins. was largely a taxpayer victory it was not a complete shellacking for the government since it established that section 845(b) can be enforced in the absence of regulations; and, that the applicable standard for judicial review is abuse of discretion.

The Code, legislative history, and Trans City Life Ins. all make clear that there are two rules that empower the Service to make adjustments to reinsurance transactions to prevent tax avoidance or evasion: (1) the related party rule[4] under section 845(a) that empowers the Service to make any adjustments necessary to properly reflect the amount, source and character of income; and, (2) the unrelated party rule under section 845(b), which applies only if the reinsurance transaction has a "significant tax avoidance effect", and empowers the Service to make any adjustment necessary to eliminate the tax avoidance effect. In enacting section 845 Congress intended that the Service have greater latitude to make adjustments to eliminate tax avoidance or evasion from related party reinsurance agreements than from reinsurance agreements involving unrelated parties. Consequently, the standards for making adjustments in related party reinsurance agreements are lower than those with respect to agreements involving unrelated parties. In this regard, the Conference Report at 1062 states:

This unrelated party reinsurance rule differs from the general related party reallocation authority in that before making adjustments under this second rule, the Secretary must determine that there is a "significant tax avoidance effect" to the reinsurance agreement as opposed to meeting the lower standard of "necessary to effect the proper source and character of income." Any transaction that would be within the scope of the unrelated party rule but for the fact that the parties are related, would

[4] The American Jobs Creation Act of 2004 modified section 845(a) for risks reinsured after October 22, 2004. The wording changed from, "… if he determines that such allocation, recharacterization, or adjustment is necessary to reflect the proper source and character of the taxable income…" to "… if he determines that such allocation, recharacterization, or adjustment is necessary to reflect the proper amount, source, or character of the taxable income…". The legislative history accompanying this change states that, "No inference is intended that present law does not provide this authority with respect to reinsurance agreements." Section 803 of the American Jobs Creation Act of 2004, Pub. L. No. 108-357.

be within the scope of the related party reinsurance rule. On the other hand, a transaction which would not give rise to adjustments if entered into by unrelated parties might result in adjustments as among related parties.
1984-3 C.B. (Vol. 2) at 316.

Turning to the specific question presented here, we note that the conference reports refer to section 845(b) as the unrelated party rule. However, the specific wording of the statute does not prohibit its application in a related party transaction. Section 845(b) applies if the reinsurance agreement has a significant tax avoidance effect on any party to the agreement. COMPANIES E and F are related parties, and they entered into a reinsurance transaction which resulted in: (1) COMPANY F having taxable income available to absorb SRLY[5] tainted net operating losses of AMOUNTs O and P for YEARs 7 and 8; and, (2) COMPANY E to avoid paying tax on additional AMOUNTs U and V for the YEARs 7 and 8, respectively. The Conference Report at 1063 specifically states that a reinsurance transaction that eliminates the SRLY taint of a previous net operating loss is a reinsurance transaction with a tax avoidance effect. It follows that the tax avoidance requirement has been satisfied. The only question is whether this tax avoidance is significant?

The conference report states that a tax avoidance effect is significant "if the transaction is designed so that the tax benefits enjoyed by one or both parties to the contract are disproportionate to the risk transferred between the parties." H. Conf. Rept. 98-861, at 1063; 1984-3 C.B. (Vol. 2) at 317. This test focuses on the economic substance of the agreement, and the conference report sets forth seven factors that help determine an agreement's economic substance. These factors are: (1) the duration or age of the business reinsured; (2) the character of the business reinsured; (3) the structure for determining the potential profits of each of the parties and any experience rating; (4) the duration of the reinsurance agreement between the parties; (5) the parties' right to terminate the reinsurance agreement and the consequences of a termination; (6) the relative tax positions of the parties; and (7) the general financial situations of the parties. In addition, the court in <u>Trans City Life Ins. v. Commissioner</u>, <u>supra</u>, at 303 – 310, analyzed two additional factors: (8) risk transferred versus tax benefits derived; and, (9) state determinations.

Factors (1) – (5), (7) and (8) are irrelevant, and thus neutral, in analyzing this specific transaction, in part because the parties are related, and tax avoidance effect is a given. Factor (6) is the relative tax positions of the parties. This is a factor to be considered in determining tax avoidance effect because the economic value of income and deductions depends on the tax bracket of the insurer. Bracket shifting is possible

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[5] A foreign insurance company (COMPANY F) that elects to be treated as a domestic corporation, and is treated as a member of an affiliated group, is a duel resident corporation. Treas. Reg. § 1.1503(d)-1(b)(2)(ii). Under I.R.C. § 953(d)(3) COMPANY F's losses are dual consolidated losses for purposes of I.R.C. § 1503(d), without regard to I.R.C. sec. 1503(d)(2)(B). Therefore, COMPANY F losses are subject to the SRLY restriction (taint), (i.e., the losses can only offset its own income).

between profit (COMPANY E) and loss (COMPANY F) insurers. This factor clearly supports the Service. Factor (9) is state determinations. STATE Z did approve the reinsurance transaction between COMPANIES E and F. This is no surprise since COMPANIES E and F are related companies within the COMPANY A group. (See Exhibit 1). STATE Z's action is in our opinion irrelevant, and thus neutral. The court in Trans City Life Ins. v. Commissioner, supra, at 303 – 310, analyzed the nine factors to determine if the transaction had a significant tax avoidance effect. As previously discussed, the only question here is whether the tax avoidance effect (elimination of SRLY taint and bracket shifting) is significant. In our opinion the large amount of tax avoided by this reinsurance transaction makes it significant.

In Trans City Life Ins. v. Commissioner, supra, the taxpayer argued that the significant tax avoidance effect standard in sec. 845(b), without regulations to explain it, violated the Due Process Clause of the Fifth Amendment because it did not set forth an ascertainable standard. The court rejected this argument, therefore, the only arrows[6] Company A has left in its quiver are the arguments that: (1) the reinsurance transaction between COMPANIES E and F had a legitimate non-tax business purposes; and, (2) the reinsurance contract was arms length. Even if these arguments are accepted as true, the arrows still miss the mark. The legislative history makes clear that the motivation of the parties, the business purpose, the fact that the reinsurance transaction was not entered into with tax avoidance or evasion as a principal purpose, and/or the fact that it was entered into at arm's length is irrelevant.1984-3 C.B. (Vol. 2) 316. In order to prevail COMPANY A will have to convince a court that: (1) a transaction specifically listed in the legislative history as an abuse should be accepted as a legitimate transaction; and, (2) the Service abused its discretion by making the adjustment. The adjustment proposed by the Service is not merely appropriate, but absolutely necessary. Further, absent full concession by COMPANY A, it should be litigated.

CONCLUSIONS:

The reinsurance transaction between COMPANIES E and F should be disallowed under § 845(b).

DISCLOSURE STATEMENT:

This writing may contain privileged information. Any unauthorized disclosure of this writing may undermine our ability to protect the privileged information. If disclosure is determined to be necessary, please contact this office for our views. This document should not be used or cited as precedent.

[6] The transaction at issue here is not included in the safe harbor provisions set forth in the legislative history.

If you have any questions please contact Joseph F. Long at (860) 290-4090.

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