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Memorandum

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Associate Area Counsel
(CC:LB&I:CTM:DEN)

from: Alexis A. MacIvor
Branch Chief, Branch 4
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subject: Life Reinsurance Business Acquisition

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

LEGEND

Parent =

Subsidiary =

Seller =

Date 1 =

Date 2 =

Year 1 =

Year 2 =

Year 3 =

#A =

#B =

$U =

$V =

$W =

$X =

Y% =

ISSUES

Whether Subsidiary entered an assumption reinsurance arrangement with Seller when it acquired Seller's life reinsurance business and, therefore, must amortize the excess of the ceding commission over the section 848 specified policy acquisition expenses.

CONCLUSIONS

Subsidiary entered an assumption reinsurance arrangement with Seller when it acquired Seller's life reinsurance business and, therefore, must amortize the excess of the ceding commission over the section 848 specified policy acquisition expenses.

FACTS

Parent, a holding company, indirectly owns 100% of Subsidiary, a life insurance company under section 816(a). In Year 1, Subsidiary purchased certain assets used in Seller's life reinsurance business in an applicable asset acquisition under section 1060 and entered into a retrocession agreement with Seller for a specified number of Seller's life reinsurance contracts (the "Transaction").

As part of the Transaction, Subsidiary entered into a Master Asset Purchase Agreement (the "Agreement") with Seller on Date 1, Year 1. Amendment No. 1 to the Agreement was executed on Date 2, Year 1 and the Transaction closed on Date 2, Year 1.

The Agreement provides the following:

> WHEREAS, Seller is engaged in, among other things, the marketing, issuance and administration of its Life Reinsurance Business;
>
> WHEREAS, subject to the terms, conditions and limitations set forth in this Agreement, Seller desires to sell, and [Subsidiary] wishes to purchase, such Life Reinsurance Business;

The Agreement defines the term Life Reinsurance Business to mean the life reinsurance business of Seller, as currently conducted by Seller, assumed by Seller pursuant to the life reinsurance contracts.

The Agreement also provides the following:

> This Agreement (including the Ancillary Agreements . . . and the other agreements contemplated hereby and thereby, and the Exhibits and Schedules hereto and thereto) contains the entire agreement among the parties with respect to the subject matter hereof . . . .

The Ancillary Agreements include the Retrocession Agreement and the Exhibits include an unexecuted Form of Novation and Release Agreement.

Pursuant to the Retrocession Agreement, Subsidiary assumed the Life Reinsurance Agreement Liabilities (the insurance risk attributable to Seller's life reinsurance contracts) on a 100% coinsurance indemnity basis. Subsidiary agreed to maintain the 100% coinsurance and to provide administrative services with respect to each of the life reinsurance contracts until their natural expiration or until the Subsidiary and Seller obtained an executed novation and release agreement from each company Seller reinsured ("Retrocedent") with respect to such contracts.

Under the administrative services provisions of the Retrocession Agreement, Retrocedents paid their premiums directly to Subsidiary and, among other duties, (1) Subsidiary paid all claims under the life reinsurance contracts, (2) Subsidiary agreed to be sued and to defend, at its own expense, any action brought against it, or any action naming Seller as a defendant, with respect to the life reinsurance contracts, and (3) Subsidiary had control and direction over litigation with respect to the life reinsurance contracts and, provided it obtained written consent from Seller, has the authority to settle or consent to judgment in any such litigation.[1]

Under the Agreement, Subsidiary and Seller agreed to use commercially reasonable efforts to obtain executed novation and release agreements from #A Retrocedents for approximately #B life reinsurance contracts. Subsidiary and Seller further agreed that, upon receipt of an executed novation and release agreement from a Retrocedent: (1) Subsidiary shall be substituted for Seller under the life reinsurance contracts, in Seller's name, place and stead; (2) Seller shall be deemed to have ceased to be a party to, and will not reinsure, the life reinsurance contracts, and shall forever be discharged

[1] The Retrocession Agreement provides that Seller shall not unreasonably withhold, condition, delay, or deny consent. Also, Seller's consent shall not be required where: (i) all settlement amounts with respect thereto are Life Reinsurance Agreement Liabilities; (ii) the settlement or judgment does not impose any obligation (other than the payment of monetary amounts by Subsidiary on behalf of Seller), limitation or injunction on, or any admission by, Seller; and (iii) Subsidiary obtains a complete release of, or a dismissal with prejudice of claims, against Seller with respect to such litigation.

from all obligations and liabilities thereunder to the Retrocedent; and (3) Retrocedent will look solely to Subsidiary for performance of any and all obligations and liabilities owed to the Retrocedent under the retroceded life reinsurance contracts.

Subsidiary and Seller negotiated the terms of the novation and release agreements with some Retrocedents that requested modifications to the Form of Novation and Release Agreement attached to the Agreement. By Date 2, Year 2, Subsidiary and Seller obtained novation and release agreements for Y% of the retroceded life reinsurance contracts. Subsidiary and Seller obtained novation and release agreements for the remaining retroceded life reinsurance contracts by Date 2, Year 3.[2]

For statutory accounting purposes, both Subsidiary and Seller treated the reinsurance portion of the Transaction as indemnity reinsurance under SSAP No. 61, Life, Deposit-Type and Accident and Health Reinsurance. Subsidiary assumed $U of net aggregate reserves for life contracts, and recognized an initial ceding commission of $U.

For federal income tax purposes, Subsidiary treated $V as ceding commissions, capitalizing $W as section 848 specified policy acquisition expenses and deducting the remaining $X in Year 1.

LAW

Specified Insurance Contracts and Policy Acquisition Expenses

Section 848 provides that an insurance company, whether subject to tax under Part I or Part II of subchapter L, must amortize its "specified policy acquisition expenses" for the taxable year. In lieu of identifying the specific expenses that must be capitalized, section 848 requires a company to amortize an amount of otherwise deductible expenses equal to specified percentages of the net premiums for certain types of "specified insurance contracts."

Section 848(e)(1)(A) defines the term "specified insurance contract" as any life insurance, annuity, or noncancellable accident and health insurance contract (or any combination thereof). For purposes of section 848, a reinsurance contract is treated in the same manner as the reinsured contract. Section 848(e)(5). In addition, section 848(g) provides that nothing in any provision of law, other than section 848 or section 197, "shall require the capitalization of any ceding commission . . . under any contract which reinsures a specified insurance contract."

[2] The novation provision in the Agreement provided an 18-month window to effect novations. At least Y% were completed within this window. Even though Date 2, Year 3 was beyond this window, Subsidiary represents that the 18-month period was established to clarify expectations to complete the novations, but was not intended to be a hard deadline as long as commercially reasonable efforts were made to novate the life reinsurance contracts.

Section 197

Section 197 provides for an amortization deduction with respect to any "amortizable section 197 intangible." The amount of the deduction is determined by amortizing the adjusted basis of such intangible asset ratably over a 15-year period. Section 197(a).

The term "amortizable section 197 intangible" means any section 197 intangible acquired by the taxpayer and held in connection with the conduct of a trade or business or an activity described in section 212. Section 197(c); Treas. Reg. § 1.197-2(d). The term "section 197 intangible" includes assumption reinsurance contracts. Section 197(d)(2); Treas. Reg. § 1.197-2(c)(2).

Treas. Reg. § 1.197-2(g)(5)(i) provides that section 197 generally applies to insurance and annuity contracts acquired from another person through assumption reinsurance, as defined in Treas. Reg. § 1.809-5(a)(7)(ii). Treas. Reg. § 1.197-2(g)(5)(i) further provides the following:

> 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.

In the case of any amortizable section 197 intangible resulting from an assumption reinsurance transaction, the amount taken into account as the adjusted basis of such intangible is the excess of the amount paid or incurred by the acquirer under the assumption reinsurance transaction, over the amount required to be capitalized under section 848 in connection with such transaction. Section 197(f)(5).

Indemnity and Assumption Reinsurance

In general, reinsurance is a transaction in which one insurance company transfers all or a portion of the risk arising out of an insurance policy to another insurance company. The insurance company that transfers risk in the transaction is referred to as the ceding company. The insurance company that assumes risk in the transaction is referred to as the assuming company or reinsurer.

Reinsurance may be classified as either indemnity reinsurance or assumption reinsurance. In an indemnity reinsurance arrangement, the ceding company remains solely liable to the policyholders and passes a portion or all of the insured risk to the reinsurer. Treas. Reg. § 1.809-4(a)(1)(iii). An indemnity reinsurance arrangement is "[a] form of reinsurance under which the risk is passed to the reinsurer, which indemnifies the ceding company for losses covered by the insurance agreement. The ceding company retains its liability to and its contractual relationship with the insured." John E. Tiller, Jr. and Denise Fagerberg Tiller, *Life, Health and Annuity Reinsurance* 716 (4th ed. 2015).

In contrast, assumption reinsurance is an arrangement in which the assuming company (the reinsurer) becomes solely liable to the policyholders on the contract transferred by the ceding company. Treas. Reg. § 1.809-5(a)(7)(ii). "Assumption reinsurance is a process whereby the obligations and the relationship to the policyholders both legally shift from the original direct writing company . . . to the new insurer . . . . Effectively, assumption reinsurance is the sale of 100% of the transferring insurer's interest in a block of business." Tiller at 157. *See also Beneficial Life Ins. Co. v. Commissioner*, 79 T.C. 627, 645 (1982), *nonacq. on other grounds*, *1984-2 C.B. 1*.

Regardless of whether parties enter an indemnity or assumption arrangement, the reinsurer usually pays the primary insurer a ceding commission for the right to future profits under the contracts acquired. *See Colonial Am. Life Ins. Co. v. Commissioner*, 491 U.S. 244, 251 (1989).

Retrocession is a contract for reinsurance of reinsurance and, in general, is treated synonymously with reinsurance transactions. 7-71 *Appleman on Insurance Law* § 71.02 (Library Edition 2015). Parties may enter a retrocession arrangement on an indemnity or assumption basis. *See ReliaStar Life Ins. Co. v. IOA Re, Inc.,* 303 F.3d 874 (8th Cir. 2002) (indemnity); *American Bankers Ins. Co. of Florida v. Northwestern Nat'l Ins. Co.,* 198 F.3d 1332 (11th Cir. 1999) (indemnity); *Beneficial Life,* 79 T.C. 627 (assumption).

Section 1060 Applicable Asset Acquisition

The purchase price allocation rules under section 1060(a) apply to any transfer of assets that constitutes an "applicable asset acquisition." Section 1060(c) defines "an applicable asset acquisition" to mean any transfer, whether direct or indirect, of a group of assets constituting a trade or business with respect to which the purchaser's basis is determined wholly by reference to the consideration paid for such assets. Under Treas. Reg. § 1.1060-1(b), a group of assets constitutes a "trade or business" if the use of those assets would constitute a trade or business for purposes of the section 355 divisive reorganization provisions, or if the character of those assets is such that goodwill or going concern value "could under any circumstances attach to such group."

Sections 338(b)(5) and 1060(a) and the regulations thereunder mandate the use of a residual method of allocation to allocate the purchase price among the assets purchased. Under the residual method, the assets of a going business must be placed into the seven distinct asset classes designated under Treas. Reg. § 1.338-6. Treas. Reg. § 1.1060-1(c).

ANALYSIS

You asked for advice regarding whether Subsidiary entered an assumption reinsurance arrangement with Seller when it acquired Seller's life reinsurance business and, therefore, must capitalize and amortize the excess of the ceding commission over the section 848 specified policy acquisition expenses.

Under the Transaction, Subsidiary purchased certain assets used in Seller's life reinsurance business in an applicable asset acquisition under section 1060 and entered into a retrocession agreement with Seller for a specified number of Seller's life reinsurance contracts. Sections 338(b) and 1060 and the regulations thereunder require the use of a residual method to allocate the purchase price among the assets. Under the residual method, the assets of a going business must be placed into the seven distinct asset classes as designated under Treas. Reg. § 1.338-6.[3]

In determining whether Subsidiary must amortize the excess of the ceding commission over the section 848 specified policy acquisition expenses, section 848(g) provides that nothing other than section 848 or section 197 shall require capitalization of such amount. Section 197 and the regulations thereunder provide for amortization of the cost (above the section 848 amount) of acquiring an assumption reinsurance contract when it is held in connection with a trade or business.[4] Under Treas. Reg. § 1.197-2(g)(5)(i), 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." *See also* Treas. Reg. § 1.809-5(a)(7)(ii); *Beneficial Life*, 79 T.C. at 636.

In addition, Treas. Reg. § 1.197-2(g)(5)(i) provides that section 197 applies to insurance contracts acquired through assumption reinsurance, as defined in Treas. Reg. § 1.809-5(a)(7)(ii). That regulation defines assumption reinsurance as an arrangement in which the assuming company (the reinsurer) becomes solely liable to the policyholders on the contract transferred by the ceding company.

Here, Subsidiary acquired the life reinsurance contracts and held them in connection with its trade or business. Under the Agreement, Subsidiary and Seller intended that Seller's obligations would be extinguished through novation and release agreements and agreed to use commercially reasonable efforts to cause Subsidiary to assume each of the life reinsurance contracts. In fact, as a result of the Transaction, Seller's obligations were extinguished.

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[3] The regulations with respect to section 338 provide that, if the buyer and seller make an election to treat the stock sale of an insurance company as an asset acquisition, the deemed sale of insurance contracts is treated as an assumption reinsurance transaction. In CCA 201501011 (Jan. 2, 2015), we concluded that, because the section 1060 regulations apply the principles of the section 338 regulations to an applicable asset acquisition of an insurance company, a reinsurance contract acquired as part of a section 1060 acquisition was treated as an assumption reinsurance transaction. We have reconsidered our analysis and now conclude that, in a section 1060 acquisition, the section 338 regulations apply with respect to the basis allocation rules only and do not treat the acquisition of insurance contracts as an assumption reinsurance transaction.

[4] Section 197(f)(5) provides that in the case of any amortizable section 197 intangible resulting from an assumption reinsurance transaction, the amount taken into account as the adjusted basis of such intangible under section 197 shall be the excess of the amount paid or incurred by the acquirer under the assumption reinsurance transaction, over the amount required to be capitalized under section 848 in connection with such transaction.

The novation and release agreements were part of the Transaction between Subsidiary and Seller.

> As a general rule, where a contract of insurance consists of a policy and other papers or documents, executed as a part of the same transaction, and accompanying the policy or incorporated therein by attachment or reference, they must be construed together, if possible, as constituting the contract and in determining the meaning and effect thereof. This rule applies even though the papers or documents are not attached to the policy or referred to therein, if they in fact constitute a part of the insurance transaction [and] even though they are not executed on the same day.

45 C.J.S. *Insurance* § 586; *see also Upper Deck Co. v. American Int'l Specialty Lines Ins. Co.*, 495 F.Supp.2d 1092 (S.D. Cal. 2007), *aff'd,* 549 F.3d 1210 (9th Cir. 2008) (Court sustained the arbitrator's decision that the insurance company was not liable because the insured did not comply with the insurance policy, specifically relying on the following documents that the court incorporated with the insurance policy: (1) tax advisor's opinion letter, (2) the shareholders agreement, (3) the S corporation's representation letter, (4) the warrant agreement, and (5) the share appraisal).

Pending receipt of the novation and release agreements, the Agreement provided that Subsidiary would be responsible for the life reinsurance contracts. Retrocedents paid their premiums directly to Subsidiary[5] and, among other duties, Subsidiary (1) paid all claims under the life reinsurance contracts, (2) sued or defended, at its own expense, any action brought against it, or any action naming Seller as a defendant, with respect to the retroceded life reinsurance contracts, and (3) had control and direction over litigation. These facts further support the conclusion that the reinsurance portion of the Transaction was an assumption reinsurance arrangement.

In an indemnity reinsurance arrangement, the ceding company remains solely liable to the policyholders and passes a portion or all of the insured risk to the reinsurer. Treas. Reg. § 1.809-4(a)(1)(iii); *see also* John E. Tiller, Jr. and Denise Fagerberg Tiller, *Life, Health and Annuity Reinsurance* 716 (4th ed. 2015) (ceding company retains liability). Subsidiary and Seller intended to, and did, obtain novation and release agreements from all the Retrocedents. Moreover, prior to executing the novation and release agreements, the Retrocedents paid their premiums directly to the Subsidiary and Subsidiary paid all claims under the life insurance agreements, among other responsibilities. Accordingly, the reinsurance portion of the Transaction is not an indemnity reinsurance arrangement.

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[5] *See* Assumption Reinsurance/Novation, OGC Op. No. 08-07-15, NY General Counsel Opinion No. 7-21-2008 (NY INS BUL) ("An insured who, for example, remits his insurance premiums to, files claims with, and requests policy changes through the assuming reinsurer could be found to have consented to the novation.")

In addition, if we conclude that the reinsurance portion of the Transaction is an indemnity reinsurance arrangement, we would effectively nullify the provisions in sections 197 and 848(g) that distinguish between indemnity and assumption transactions for federal income tax purposes. Due to current state insurance regulatory rules, it is unusual, if not unheard of, to implement and finalize an assumption arrangement on the same day. Therefore, companies commonly implement assumption reinsurance contracts in transactions similar to the Transaction between Seller and Subsidiary.

Subsidiary contends that the reinsurance portion of the Transaction is an indemnity insurance transaction because (1) the novations and release agreements were not part of the Transaction and were obtained in Year 2 and Year 3, and (2) the term "policyholder" in Treas. Reg. § 1.809-5(a)(7)(ii) does not include retrocedents and thus, there is no assumption reinsurance for federal income tax purposes. We disagree. As described above, the novation and release agreements were part of the Transaction, and were not separate transactions that stand alone without the rest of the Transaction. The fact that the novation and release agreements were obtained in the years immediately following the year of closing, Year 1, does not render the novation and release agreements separate transactions. Moreover, pending the receipt of the novation and release agreements, Subsidiary stepped in the shoes of Seller.

With respect to Subsidiary's second argument, the term "policyholder" is not limited to the purchaser of insurance and includes the holder (or reinsurer) in a reinsurance transaction. General insurance provisions do not support this interpretation. The term "policyholder" does not have a definite and settled meaning in insurance and may include holders of reinsurance contracts. Steven Plitt et al., 1 *Couch on Insurance* § 6:19 (3rd ed. 2016); *see also* Volume V, *Reinsurance*, NAIC 801-3 National Association of Insurance Commissioners (2015) (The Assumption Reinsurance Model Act provides a broad definition of the term "policyholder"). Here, the Retrocedents are the policyholders of the reinsurance contracts and there is assumption reinsurance for federal income tax purposes.

Consequently, for federal income tax purposes, the transfer by Seller of its life reinsurance contracts to Subsidiary is an assumption reinsurance transaction. Therefore, under section 848(g) Subsidiary must amortize the remaining $X of the ceding commission over a 15-year period. Sections 848(g), 197.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

[redacted]

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