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Reinsurance Tax Court Cases

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Summary: Many reinsurance agreements are effective because they are tax efficient. However, tax efficiency is not always guaranteed. This session reviews the results of recent tax court cases that will have an impact on the tax treatment of reinsurance agreements, including Trans City Life versus the Commissioners of the IRS.

Mr. Jeremy Starr: Our panel includes Hugh T. McCormick, who works in the New York office of LeBoeuf, Lamb, Greene & MacRae. His practice involves advising insurance companies on matters relating to insurance company taxation and regulatory matters in connection with corporate restructuring, acquisitions, reinsurance transactions and insurance products. Also Diane Wallace will present. She works for D.B. Wallace & Company. Her practice encompasses the structuring of financial reinsurance transactions, assisting in obtaining the regulatory approval for reinsurance transactions, and serving as an expert witness in several reinsurance litigations. She formerly served as vice president of the Society of Actuaries (SOA) and chair of the Reinsurance Section.

I work for The Guardian Life Insurance Company of America where I am in charge of the Reinsurance Profit Center. My responsibilities include running our mergers and acquisitions (M&A) and financial reinsurance operations. I am past chair of the Reinsurance Section.

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Our presentation will cover three primary topics. First up is a court case involving an insolvent estate where the Oklahoma Commissioner sued The Guardian. The case involves a reinsurance transaction between The Guardian, American Standard Life (ASL) and Life Assurance Company of Pennsylvania (LACOP). The primary issues involved retroactivity, set off, and recoupment. The second case will cover the Trans City Life case. It was the first and, to my knowledge, the only case that has gone through the courts regarding IRS Code Section 845. Finally, we will be talking about reinsurance and insolvent estates.

To start I'll give the history of The Guardian case involving an insolvent estate. In 1986 Life Assurance Company of Pennsylvania made the decision to acquire United Republic Life Insurance Company. In order to finance that transaction, The Guardian provided financial reinsurance to United Republic. This allowed the seller to realize the selling price partially from the results of the reinsurance agreement and the rest from the purchase price paid by Life Assurance Company of Pennsylvania. Once United Republic was owned by Life Assurance Company of Pennsylvania the responsibility to repay the reinsurance agreement was now on the new owner. After requiring a few modifications to the agreement, the Pennsylvania Insurance Department approved the transaction as having achieved full risk transfer. About a year later, Life Assurance Company of Pennsylvania decided to sell United Republic's in-force business because they could not properly administer the block of business. It found a buyer in American Standard Life of Oklahoma.

American Standard, however, was not licensed in Pennsylvania and therefore applied to Pennsylvania to gain a license. Pennsylvania would not grant a license to the company, but would give it authority to be an accredited reinsurer. The American Standard and Life Assurance Company of Pennsylvania then entered into both a 100% co-insurance agreement and an agreement to have American Standard administer the business. American Standard was a small life insurance company operating out of Oklahoma City. Its primary business was acquiring small blocks of business and running them off. In 1986 there was a triennial exam, which to my knowledge has never been publicly released. As a result of this triennial exam, Oklahoma put American Standard into informal state supervision. This means that all transactions done after supervision began were reviewed and approved by the state. This state supervision status did not become public knowledge until it was revealed as part of The Guardian court case.

When Life Assurance Company of Pennsylvania and American Standard entered the co-insurance agreement it was agreed that they would continue to lobby the Pennsylvania insurance department to allow the agreement to be converted to an assumption reinsurance basis. The Guardian, with that in mind, amended its agreement with Life Assurance Company of Pennsylvania to say that if the

agreement between Life Assurance Company of Pennsylvania and American Standard became an assumption agreement, then The Guardian would agree to assign the agreement to American Standard. Because the assumption never occurred, The Guardian's legal liability remained as Life Assurance Company of Pennsylvania's reinsurer. By 1991 it became apparent to Oklahoma regulators that the informal supervision was not working and so an order of conservatorship was sought and obtained. During this entire time the reinsurance agreement was maintained as if American Standard was not impaired. The state knew about the provisions of the reinsurance agreement and encouraged the Guardian to keep it in force. Their valuation actuary, in the year-end certification, acknowledged the legitimacy of the agreement. However, in 1992, the state decided that the agreement did not comply with a 1988 Oklahoma risk transfer law.

Mr. Gerald Kopel: If the agreement went into effect in 1986, how much surplus relief was left in 1992?

Mr. Starr: The agreement was amended a few times after the inception date to provide additional surplus relief, and thus there was still an outstanding balance in 1992.

The Guardian's original agreement was placed in 1986. American Standard first became involved in 1987. In 1988, a year later, Oklahoma passed 36OS1928. The law is modeled after the 1985 NAIC Risk Transfer Regulation. The regulation laid out eight points that an agreement could not contain if reinsurance treatment was to be allowed. Should an agreement fail these tests, the NAIC regulation's penalty was loss of reserve credit. In the Oklahoma act, the penalty is denial of set off.

Mr. Hugh T. McCormick: We were the litigators who handled the American Standard case for Guardian. Jeremy has done a good job of describing the background of the case. Let me just read from a brief that was recently filed by the Receiver's Counsel down in Oklahoma as part of a motion for a rehearing of the Supreme Court case that I'll describe to you in a second. They described the situation as follows: "There was a hole in the estate of American Standard Life Insurance Company. The size of the hole is yet to be established, but no one doubts that it's there. This action is about who will fill that hole. Will it be the Guardian Life Insurance Company of America, a multi-billion-dollar insurance company, which assisted American Standard Life in concealing its perilous financial condition from regulators, thus ultimately increasing the magnitude of American Standard Life's insolvency? Or, will it be the taxpayers of Oklahoma and the other states who, under tax-offset statutes, will ultimately foot the bill for any amounts paid by Guaranty Associations like Oklahoma Life and Health Guaranty Association (OHLGA)?"

Oklahoma Life and Health Guaranty Association is the Oklahoma fund that will be required to fill the hole in American Standard Life. That kind of sums up this case; it's about "deep pockets," which is something perhaps actuaries don't deal with all the time, but lawyers do. This is a case in which the lawyers look around, find out where the money is and then go for it.

In this case, I think that what we learned at trial, and going through the course of the case, is that the State of Oklahoma didn't really have much of a claim against Guardian. But there was a lot of money there, and they could "gin up" a case, and they were in their own court. So, as the lawyers say, why not? I'll quickly walk through the procedural posture of the case, and then talk about the holding. The case pointed out some of the difficulties of the American legal system. It was filed in 1991. It started out in the state receivership court in Oklahoma. We removed to Federal court because of the multi-state jurisdiction. The Federal court remanded to State court. In the State court we then moved to enforce the arbitration clause in the treaty. The state receivership court ruled in our favor, and ordered arbitration.

The receiver took the arbitration order up to the Oklahoma Supreme Court where they obtained a judgment that the arbitration clause need not be enforced because the matter at issue was statutory, not contractual. That was our first visit to the Oklahoma Supreme Court, where we lost. We were sent back down to the state receivership court, and the matter was tried by a judge. It was not a jury trial. Poor Judge Freeman, who is just an innocent, old country lawyer, tried the case, and he had before him a matter of actuarial science, and he had a case of dueling actuaries. He had some good ones: Dale Hagstrom, Diane, Tom Kabele, and Jeremy on one side, and he had John Tiller and Jack Turnquist on the other side. I did not participate directly in the trial and did not go to Oklahoma. That was handled by one of our litigators. I've read the reports on the case and our experts, who I know well and respect highly, stood up and said that under the relevant regulations, this treaty transferred risk.

Art Dummer, who drafted the treaty, more or less said the same thing and at one point, I think even the receiver's actuary implied that there was risk transfer. I'm turning to Diane and Jeremy because they were there for that testimony. Didn't the receiver’s actuary at one point testify that the treaty passed risk?

Ms. Diane Wallace: They took reserve credit under the same language.

Mr. McCormick: Nevertheless, Judge Freeman, in his wisdom as a certified actuary, as well as lawyer and judge, decided that there was no risk transfer, and the treaty was a sham treaty. At that point we appealed his rather startling decision. We went back up to the Oklahoma Supreme Court, which sent us back down to an

intermediate level court, which in a two-page opinion resolved several issues that had never been raised on our appeal. So at that point, we then appealed back up to the Supreme Court, where we no longer had an appeal of right. We had to file a petition for certiorari, which they can accept or reject as they wish. We had already filed all the briefs, so there were not really any new briefs filed. It sat there for a relatively long period of time.

Now I'm going to tell you a true story. I'm a runner. I was out for a run one Saturday and when you go out for seven, eight, nine miles, you get bored after a while, and you start daydreaming. I was daydreaming this particular Saturday, "What good could happen this coming week?" I said to myself, "We could get a decision from the Oklahoma Supreme Court ruling in our favor." I immediately dismissed the thought. So Tuesday I walked into the office and there was a telephone note from our co-counsel in Oklahoma saying the Oklahoma Supreme Court just ruled in our favor.

The Supreme Court ruled absolutely in our favor. It was just a hands-down victory for Guardian, out of the blue, no argument, no additional motions, no additional papers filed. It came as a complete shock to all of us, but a very pleasant shock. Immediately, the receiver filed a motion for rehearing, not surprisingly, and that motion is still pending. Subsequent to the motion for rehearing and the judgment in our favor, there was a further development. Our co-counsel in Oklahoma had also worked on obtaining a legislative clarification. An important point, from the Oklahoma Legislature as to their intent when they passed the risk-transfer statute in 1988, was whether to apply retroactively.

In March we were successful in obtaining a legislative correction; it's what we call a clarification of the intent of the legislature. It says they did not intend that the statute was to apply to an in-force treaty. It was only to apply to treaties that were entered into after the effective date which, of course, had the effect of eliminating the Guardian-ASL Treaty from application of the risk-transfer statute. We submitted that legislation to the Oklahoma Supreme Court. In the most recent round of briefs that we received just the other day, the receiver is now saying that if we needed an amendment to the statute to exclude treaties entered into before the original effective date, before that amendment was made, treaties entered before the original effective date, and challenged before the amendment was made, were not protected. In essence, the argument is that every pre-1988 treaty other than the Guardian Treaty is protected.

That's where the argument is right now, but in their own briefs the receiver's counsel has conceded that if the act of the legislature is a clarification of the old law, they lose. If it's an amendment of the old law, they claim, they win. Our

argument of course is exactly what you'd expect. We view it as a clarification of what the intent was at the time of enactment. So on that analysis we should win. The other side of that case is that this legislation wasn't enacted until after we had a binding judgment of the Oklahoma Supreme Court that the intent of the legislature was not to have retroactive legislation. We can argue that this legislative clarification is irrelevant because the Supreme Court of the state had already decided. It's kind of a convoluted way of saying that things can get tied up in courts forever, which even the lawyers stop loving after a while. We do make money from it, but at some point you just want to say, "Stop, please stop."

His decision turned, among other things, on a finding of an intent to deceive the regulators, that the treaty was a sham treaty because there was no risk transfer.

He ruled that Guardian knew or should have known of American Standard's insolvency at the time they allowed the transfer of this treaty from Life Assurance Company of Pennsylvania to American Standard. In the end, he also came down with a judgment as to damages that actually exceeded the claims that Guardian would have paid on the business, had they written it directly, because he ended up in a situation where he was allowing double counting. As I remember he was allowing both the actual payment of benefits, but then he was adding to this, the deemed payment of the modified co-insurance credits, which was the way it was going to reserve credits. So he was doubling up.

Mr. Starr: There was a feature in the agreement that started to look like an experience refund. It wasn't, but his opinion was that we couldn't get the premiums, but we would have to pay an experience refund anyhow, that counted the premiums as being received.

Mr. McCormick: So let me just walk through some of the facts, what I call the true facts, as opposed to Judge Freeman's facts. First, the treaty with Life Assurance Company of Pennsylvania, this supposed sham treaty, had been reviewed by and approved by the Pennsylvania Insurance Department. There is a letter in the file from Ron Chronister, to the effect that they had some problems with the modified co-insurance interest rate; as I remember, Life Assurance Company of Pennsylvania could not take full reserve credit for the treaty when it was first entered into, but partial credit was allowed nonetheless, and it was not treated as a sham treaty by Pennsylvania. Second, Judge Freeman found that Guardian knew or should have known that American Standard Life was insolvent. American Standard Life showed statutory profits on its annual statement for each of the years at issue.

With regard to deceiving the regulators, the Oklahoma Insurance Department knew as early as the end of 1985 that American Standard Life was impaired and had what

I think we regard as a secret supervisor on the scene. The Department said nothing publicly, but they had a supervisor involved in running the company as of the end of 1985, early 1986. Also, the Department wanted the treaty. They induced Guardian to stay on the treaty even after they put the company under supervision because they wanted the surplus credit. They were trying to rehabilitate the company and they needed the surplus relief and the Guardian Treaty was important to them. So they continued the treaty and they've now accused Guardian of sleeping on its rights by not disavowing the treaty early on.

Finally, there's the whole issue of whether Guardian participated in a deception. It was found that Guardian went into this transaction to deceive the Oklahoma regulators, which I always found puzzling because I thought Guardian went into a treaty with a Pennsylvania company to provide surplus relief. Oklahoma has presented this case as if Guardian were a conspirator with American Standard Life which, according to my understanding of the facts, is very much untrue. The receiver presents this case as if American Standard Life’s problems, in part, stem from this surplus relief treaty. In fact, Dave Nicholas, who owned American Standard Life, took a lot of the money of the company, not from this treat. He took a lot of the money generated by the business they were writing and bought a fishing ranch in Colorado, which immediately went from $16 million in real value to a negligible value. I think it's gotten back up to $4 or $5 million at this point. So the problem was management, and the problems were on the asset side, not on the reinsurance nor the liability side.

Those are the "true" facts. You can't really try facts in an appellate court. The trial court's decision, unless it's totally unreasonable, is binding, and you do not appeal facts up to an appellate court. You appeal law. Nevertheless we did try to work some of this factual background into the papers that we prepared. We were quite offended by the behavior of the Oklahoma Insurance Department. We think that they behaved poorly and we said that in some of the papers that we filed.

The decision of the Oklahoma Supreme Court in our favor is based solely on the issue of retroactivity. The decision turns on the issue of whether the legislature intended to make this legislation apply to treaties entered into before the effective date, and the Oklahoma Supreme Court concluded that this was not the case. Their decision was that the Oklahoma Legislature intended the risk-transfer statute to apply only to treaties entered into after the effective date. But then they went on for a couple of more pages, on various other issues that they could have decided. I read between the lines in this case that the Oklahoma Supreme Court had begun to understand that this was a case of the regulators having overstepped their bounds in a number of ways. Your expectation is that the local court would rule in favor of the local guaranty fund and the local insurance department. Instead, they ruled in

favor of the billion-dollar insurance company that supposedly assisted the local company in becoming insolvent. So I think we were successful in conveying a sense of outrage.

The court ruled that a retroactive application of the risk-transfer statute would have impaired Guardian's vested contract rights to net accounting (i.e., offset). This treaty was set up on a net accounting basis, as they typically are. I don't pay you X and you pay me Y, but rather you pay me the net of X and Y; or I pay you the net of X and Y; that's what the treaty called for. The Supreme Court concluded that applying the risk-transfer statute to this treaty on a retroactive basis would have really required, in essence, reforming or rewriting the treaty so that there would be actually a recitation of payments over and payments back; these would be separated conceptually into different obligations. To make the risk-transfer statute work the way the Oklahoma Department wanted it to work, having created these two separate obligations running one way and the other, they would then interpose the statute between the two and say that Guardian has to pay its obligations, but the American Standard Life estate does not have to currently pay its obligations; rather it must pay at the end of the insolvency. The Guardian, in other words, would become a general creditor of the insolvent company. The Oklahoma Supreme Court concluded that this was a fundamental variation from the contract as drafted, and that interposing this risk-transfer statute retroactively would have changed that vested contractual right.

The court did not address one issue that we raised at great length—whether or not within one contract with net accounting, you even have an offset issue. Offset concerns mutual debts between two different parties and clearly it applies if there are two different treaties and profits under one, losses under another, and you try to offset those two items. That is a clear case of the traditional right of offset. When you have net accounting, as you typically do inside of most reinsurance treaties, and certainly do in most or all of the modified co-insurance treaties, an entirely different concept arises, which is an old common law concept known as "recoupment." Recoupment is not dependent upon the concept of offset; it's dependent upon the concept that as a matter of contract you come out with a net number.

We argued strenuously, with the support of some U.S. Supreme Court cases and local cases, that the offset statute doesn't apply at all to a single treaty situation. I think it's a legally sound argument. I was never totally convinced that I would ever win on that argument because the risk-transfer statute was drafted with a single treaty in mind. The legislature clearly had single treaty in mind, even though they used the term "offset." But we never got to that point because, again, the court turned on this very narrow issue of retroactivity.

Something that was interesting for the future is that the receiver continued the treaty in force after the beginning of the insolvency proceeding. There is an old legal concept—election of remedies. The receiver can reject the treaty, or he can continue the treaty, but he can't do both. The receiver tried to continue the treaty for a period of time, and then subsequently rejected the treaty. The court, almost by direct statement, but clearly by implication, felt that this was improper. There was a point of time when the receiver could have rejected the treaty, or as they did, elect to continue the treaty. Once they elected to continue the treaty, then they take it. An old Latin phrase, which shows up in bankruptcy law, *cum onere,* means that when you continue the treaty, you take it with its benefits, but you also take it with its detriments.

One of the detriments in this case was the net accounting. One of the readings of the case is that the receiver had overstepped her rights by attempting to continue the treaty while the surplus relief was running down, but once the surplus relief ran down, she rejected the treaty. In essence, the receiver had given away her rights to reject a treaty at an earlier point in time. In terms of the future, this law is still a good law in Oklahoma. It's an unusual law, and the only law of its kind in the 50 states, at least that we're aware of. It is probably constitutional. It was enacted pursuant to the police power of the state. When you go into a treaty with an Oklahoma company, you go into that treaty knowing that's the law and that it will be binding upon you. If you go into a treaty tomorrow and ran afoul of this statute, you could have a very tough time beating it on constitutional grounds.

If you're looking at treaties in Oklahoma, I'd be very careful. It may not really be an issue and I don't think that this concept is spreading. The denial to offset, of course, is an issue that's being litigated in state courts. There are bad decisions in Colorado and Pennsylvania. There are good decisions in New York and California, and there's a case working its way through Illinois, I believe, where there was a very good Federal decision a number of years ago, but there are still some issues at the state level in Illinois.

Mr. Starr: As far as the possibility of an Oklahoma-style denial of set off spreading to other jurisdictions, Pennsylvania was looking to do just that last year. The industry has temporarily defeated this proposal and, with the Oklahoma decision behind us, it probably will not be refiled in Pennsylvania. Let's hope that the *Mission* case in California that was settled in favor of the industry will be the basis of decisions elsewhere.

Mr. McCormick: Didn't the California Supreme Court ruled in favor of the right of offset in the *Mission* case?

Mr. Starr: Because of the uncertainty of the right of setoff in California many reinsurers did not get involved with financially oriented reinsurance agreements in California.

Ms. Wallace: There's legislation now in California as well that clarifies the right to offset. So I think it's pretty safe.

Mr. McCormick: The California Insurance Department was not letting you put the right to offset language in treaties.

Ms. Wallace: They do now; that's taken care of.

Mr. McCormick: That's over now.

Mr. Starr: A problem in a number of these situations is that the receivers are unencumbered by financial constraints when they bring questionable legal actions. Is it not true that the funds for any lawsuit brought by the receiver comes out of the insolvent company's estate?

Mr. McCormick: Yes, it typically comes out of the estate of the insolvent company.

Mr. Starr: Therefore, there is absolutely nothing to stop the government because it doesn't show up in its budget.

From the Floor: There are two other questions I don't think you really covered. First, according to this law, any one of those list of conditions is sufficient to deny risk transfer or show that there was no risk transfer; it does not have to be all of the them.

Mr. McCormick: Yes, that's right.

From the Floor: I don't see how that's justified. Second, why does lack of risk transfer justify denying offset?

Mr. McCormick: Because the legislature says it does—that's the only answer I can give to your first question. Because of the failure to comply with any one of the criteria, the Model regulation would say that there is a lack of risk transfer, and you would lose reserve credit. In Oklahoma, if you fail to comply with any one of the criteria you would likewise lose the right of offset.

From the Floor: That's totally different.

Mr. McCormick: I understand but, the way the statute works and the way I think it was drafted to work, is in any situation in which you would lose reserve credit, you would also lose the right of offset, which is one of the interesting issues in this case. American Standard Life never lost reserve credit, or they didn't until late in the proceedings, to buttress their legal case.

From the Floor: That was what was striking about it. The wording in those conditions came right out of New York 102, which is kind of strange.

Ms. Wallace: We probably have to move on, but I'll just make one comment. An Insurance Department representative in the trial made the statement that they passed the law because they needed to let insurance companies take reserve credit and get the benefit of the surplus, even if it was a bad treaty. Then they would force the reinsurer to bear the full economic brunt of the shortfall in the company. That was the whole purpose of writing a law that way, instead of denying reserve credit.

Mr. McCormick: The answer to your question is, the legislature can do what the legislature can do and, it may not be logical, intelligent or anything close, but it is within their power. After we're done, I'd be happy to answer any questions that may come up.

We're going to move on to Section 845 on which I'm going to do a quick introduction. This case involves Consumer Life. Consumer Life told you that if a treaty looked like it transferred risk, and you said that it transferred risk, and the State Insurance Department agreed that a treaty transferred some risk, you had a hunting license to go out and do tax-oriented deals. This was a great case and it supported all kinds of wonderful things.

Keep in mind that this was 1977, which was the beginning of the great days of the 820 modcos (modified co-insurance treaties); they were the tax modcos. I was with the chief counsel's office of the Internal Revenue Service at the time that the modified co-insurance rulings were sent to the IRS. These rulings basically asked a for blessing of the tax treatment of the modified co-insurance treaties. Those of you with gray hair or no hair, will remember, but some of the younger people will not remember the wonderful days of the three-phase tax system in which you could use a modified co-insurance treaty between a mutual company on one side and a stock company on the other side. This would shift income out of the taxable base for the mutual company and run it through on a tax-neutral basis through the stock company, then bring it back into the mutual company on the untaxed basis by shifting from phase one to phase two or phase two to phase one; it has been so long that I've begun to lose track. It worked marvelously.

The board of directors could sit down to decide how much federal income tax they wanted to pay in a given year, and then you would dial in your modified co-insurance treaty to produce that result. It was wonderful, and it was legal. I reviewed the statute and I reviewed the regulations, and these modified co-insurance treaties really did work. Over the years, I've talked to a lot of people, and I've asked, "Who was it that came up with this idea of the tax-oriented modcos?" Every actuary I've asked said that it was him or her.

The first legislative response was Section 818(g), which is just history. It was enacted as part of Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) and, as you can see, it picked up related party reinsurance and it gave the IRS the right to make adjustments to reflect the proper source and character of taxable income in reinsurance treaties between related parties. This obviously didn't pick up the 820 modcos because they were between unrelated parties, but this was the Service's first shot. In 1984, following the TEFRA Legislation and following all of the attention that was paid to the 820 modcos, we ended up with Section 845. As I said earlier, every actuary I've ever talked to claimed to be the author of the 820 modified coinsurance tax treaties. Every tax person in Washington claims to be the author of Section 845. They're very proud of it because it really is almost unadministerable, so it just sits out there as kind of an *in terrorem* effect on reinsurance arrangements. Section 845 is broken into two parts.

Section 845(a) addresses related party reinsurance. The IRS may make adjustments to reflect the proper source and character of taxable income. Section 845(b) is a little bit more of a problem for the Service, as they must show a significant tax avoidance effect, but the Service regards this as a very valuable tool. This provision relates to reinsurance contracts between unrelated parties. It says that the IRS may make proper adjustments to avoid any significant tax avoidance effect. Their idea of significant tax avoidance effect looks to tax benefits that are disproportionate to the risk transfer. The IRS describes this as an objective rule in one of the private letter rulings that it issued over the years.

The legislative history of Section 845 has a whole list of the kinds of factors that one is to look to in determining whether or not a treaty passes sufficient risk. There is a glossary in the legislative history on what each one of those mean. For example, with respect to duration or age of the business reinsured, the legislative history shows that there was a high risk that you would go into reinsurance treaties on new business for tax purposes, but if it's old business, you probably would not.

Diane will tell you that because of surrender charges, that's wrong; you can actually manipulate things for tax purposes in the old business as the surrender charges run off, if that's what you want to do. With respect to the character of the business

reinsured, the focus there was on whether or not there was a transfer of long-term reserves. With respect to repayment of potential profits and experience rating, they were looking at the way the treaty was set up. Was there an actual risk transfer, or was there just something that was the equivalent of an annual risk premium transfer with a financing?

With respect to duration of the reinsurance agreement, the legislative history takes the position that long-standing agreements are usually better than short-term recent agreements. With respect to the right to terminate and the consequences of termination, the legislative history basically says that if a treaty has a provision in the experience refund formula or the termination provisions of the treaties to protect the reinsurer against an early termination of the treaty, perhaps the reinsurer suffered some losses in the early years. If there is some kind of a provision to prevent the reinsurer from suffering usual losses because of early termination of the treaty, that's probably fine, but if you actually have a provision that's designed to have the ceding company pay back any losses that were incurred by the reinsurer, that is not permissible.

Other tax avoidance factors include such things as changing tax brackets, the use of net operating losses, reducing equity for the Section 809 surplus tax or the add on tax, and changing the source or character of income. The final thing that the history mentions is the general financial situation of the parties. If a company is about to go into insolvency and the reinsurance is used to keep a company out of insolvency, from a tax point of view, that's probably indicative of a good treaty. There is also a list of safe harbors. These are arrangements that would normally not be subject to Section 845. These include yearly renewable term, co-insurance of annual renewable term life insurance, co-insurance of new business allocating expenses, income in the same proportion as the allocation of the risk reinsured, and co-insurance covering existing business (if the initial ceding commission reflects past expenses and the premium paid reflects profitability). The goal here was to try to carve out from Section 845 some kind of conventional reinsurance arrangements.

Mr. Starr: When the legislation was first passed there was a clamor from the industry to develop regulations to define Section 845(b) much more clearly. In other words, what kind of reinsurance transactions would be acceptable and which would create a tax exposure? There was an industry task force created about the time Section 845 was passed. I believe Mel Young chaired the group and its charge was to develop an industry version of regulations. While the document that resulted looked fair to those who participated in the group, upon reflection, the task force felt that the document provided more education to the IRS than was desirable, therefore the industry draft was never released. The IRS came to a similar conclusion in that they realized that the fewer regulations and explanations they

had, the stronger Section 845(b) was because nobody could figure out what was safe. This is why to this day we do not have regulations on 845.

Mr. McCormick: The legislative history calls for it and anticipates that the regulations would be issued based on the factors I just went through.

Now 845(b) or 845 in general are useful to the IRS the way they sit now because the IRS administers it with no objective criteria. The IRS will tell you there's a private letter ruling, which I'll get into in a minute, but even that tells you that these safe harbors aren't really safe harbors.

Mr. Starr: Trans City Life was a small, credit insurance company operating in Arizona that wrote both credit life and disability insurance. Although they wrote more credit life than credit disability insurance, the reserving methodology resulted in Trans City having more disability reserves than life reserves. One of the tests for a life insurance company to use to determine whether it should be liable for taxes is the relationship of the statutory amount of life reserves versus the total statutory reserves held by a company. Because disability reserves are often considered to be nonlife reserves, Trans City was in danger of becoming a property and casualty company for tax purposes. To solve this problem, the company could have ceded some of their disability business and thereby increased the proportion of life to disability reserves. This would have assured them of staying a life company for tax purposes.

The alternative that the company chose was to enter into a reinsurance agreement with The Guardian, where they assumed life business. The attraction to doing this from Trans City's perspective was that they could retain the profits on their disability business while still maintaining their life status. They hoped they would also make profits on the reinsurance agreement. Entering into the reinsurance agreement would also allow Trans City to learn about the business that they were assuming. This additional knowledge could aid them with a decision on whether to enter those lines of business on a direct basis. Entering such a new line could be done with an eye towards finding a more permanent solution to the taxpayer status issue.

The Guardian was a significant financial reinsurer during the years that the Trans City/Guardian agreement was put into effect (1988–89), during which time The Guardian wrote more financial reinsurance than management desired. To bring the net amount of reinsurance placed within the levels management desired, The Guardian retroceded business. Trans City was one of the companies to whom The Guardian retroceded business. As part of the retrocession, The Guardian typically kept some of the gains on the business that was retroceded. The first treaty, written in 1988, covered single premium deferred annuities (SPDA) issued in 1984–85.

The reinsurance agreement was on a combination co-insurance/modified co-insurance basis. The underlying treaty was recaptured by the original writing company in 1989.

The parties, Trans City and The Guardian, wanted to continue the relationship, so a second agreement was closed in 1989. This second agreement covered single premium life insurance business issued in 1987. The treaty terms were almost identical to the 1988 agreement it replaced. The 1989 agreement was terminated in 1993 when it was believed that the financial reinsurance had been paid back.

Mr. McCormick: The Trans City Life case ended up in tax court, and I think this was another case of dueling actuaries. Again our co-panelist, Diane Wallace, was the expert witness, but in this case, she was on the winning side. There was a fair amount of testimony at the trial and it shows up in a very lengthy, very well-considered and well-written opinion, which goes into some detail on the nature of reinsurance. Diane wrote much of it so that's why it's so well written and well considered.

Mr. Starr: Being a credit insurance case, Gary Fagg—who wrote the primary textbook on credit insurance—was also an expert witness as was their consulting actuary, who works for Watson Wyatt, Jim Gordon.

Mr. McCormick: The judge also listened very carefully to the testimony of the IRS's three consulting actuaries, and the judge's option came through very clearly that, in this case, he considered the actuarial testimony, weighed who the actuaries were and what they said, but he did not find them credible. It was a situation in which the taxpayer used the reinsurance treaty to turn itself into a life insurance company, that is, to meet the qualification ratio for tax treatment as a life insurance company. They used reinsurance agreements, with an unrelated party, so they were under 845(b), not 845(a). They were able to present a valid business purpose for the reinsurance, and argued that the treaties were not entered into for tax avoidance purposes. I'll mention in a minute that the IRS considers this very much an open issue—the validity of a valid business purpose as a defense to a Section 845 attack.

The tax court went through each of the risk transfer factors that we discussed a few minutes ago. The judge analyzed the treaty under each one of these factors and decided whether that factor favored the government, favored the petitioner, or was neutral. I think he found that none favored the government, one was neutral, and all the rest favored the taxpayer. So based on this very careful analysis of these factors, the judge came to the conclusion that 845(b) was not applicable, that there was no significant tax avoidance effect in this treaty, and that the IRS had abused its discretion in attempting to disallow the small, life insurance company deduction for

this company. It was the first case, as Jeremy said, that had come up through the court system and actually gotten into the court. It was a fairly resounding loss for the IRS because they had invested themselves in this case. They really wanted to win this case, and losing it in this very well-reasoned opinion has set them back considerably.

The people at the IRS who were involved in this case will go around to the various public meetings of insurance tax professions and tell you that they don't take this case that seriously; they don't take it as a major defeat. This was just one case and they will bring up Section 845 in other cases. They believe the court was wrong. The people at the national office in Washington will actually substitute their judgment as to whether or not there's risk transfer in a particular case for the judgment of professional actuaries. This comes through in some of the rulings that we're going to talk about in a moment.

So, in the future, although Trans City Life is a very, very good precedent and is very good for the industry, it has, to some extent, put the IRS back on its heels. Perhaps the Service doesn't want to have objective criteria. They want to be able to take everyone into court and make you fight them. Regulations would make that more difficult for them.

From the Floor: If the legislative intent of Section 845 was to have the Service develop regulations, because it has not done so thus far, does that not give the industry a basis to contest 845 based upon a failure to follow through on legislative intent?

Mr. McCormick: Not really. Congress frequently passes legislation that requires regulations to carry out the intent of the statute. This was a case where the legislative history called for regulations but didn't require them. So you actually have a distinction. There are what is known as legislative regulations, and there is interpretive legislation. These would be interpretive regulations. They are not required by the statute. There are a number of statutory provisions in which Congress says, here's the answer, but the Secretary of the Treasury is to produce the road to the answer through regulations. In this case Congress laid out the legislative history and then said it is anticipated that regulations will be issued. So the Service is not operating under a statutory requirement. Yes, there's an issue of fundamental fairness that's at work here.

From the Floor: Is there a reasonability standard involved here, due to the fact that the longer the Service takes to issue regulation, the more companies are disadvantaged by that lack of regulations?

Mr. McCormick: That was actually an issue raised during the Trans City case. One of the issues the taxpayer raised in Trans City was whether or not there was even authority to attack that treaty under 845(b) because of the absence of regulations. The judge held that the law and the legislative history gave the industry, gave a taxpayer, enough guidance as to what was required. And Section 845(b) was administrable, and therefore it was not unfair to apply Section 845(b) in the absence of regulations. So that has been litigated in the Trans City case.

I'll discuss some selected private letter rulings. We'll go through this quickly in case you want to think about things that the Service has ruled on. In the first private letter ruling (PLR), 93460004, there was a group of companies that used related-party reinsurance within its group to turn a holding company into a life insurance company. They got the holding company licensed and then used some reinsurance to "life" the company—to get it past the 50% reserve test. Why? They had some debt instruments, and the interest deductions were tied up in the nonlife group and not usable against life income. By moving assets around and then "lifting" the holding company, they turned this debt into a liability of the life group so that the interest could be deducted against life income, without the limitations under the "life-nonlife" consolidated return regulations. The Service applied 845(a) to disallow the tax benefit.

The second ruling (PLR 9339001) involved creating a life company and then taking advantage of the small, life insurance company deduction. The Service applied 845(b) in that case because it was unrelated party reinsurance. If this case was to be litigated, Trans City Life might produce a different result.

The third (PLR 9335056) was a ruling that was given in the situation involving Executive Life Insurance Company. The assumption reinsurance of the business from the insolvent Executive Life to the runoff company was held not to implicate Section 845. That was one of the few rulings in which the Service concluded 845(b) did not apply. PLR 9308003 was another ruling under 845(b), where the taxpayer was trying to take advantage of the small, life company deduction.

PLR 8825016 (supplemented by PLR 9103008) is an interesting ruling because it goes to the use of a life insurance holding company and the leveraged acquisition setting. You may have run into this situation when you have a holding company that is going to buy a life insurance company in a leveraged acquisition. Because of the life/nonlife consolidated return rules, you could not file a consolidated return for the holding company and the target. You would end up with interest deductions in a nonlife holding company, operating income in the life company, and no way to match the two.

The technique that was developed over the years is that the holding company goes out and buys a little life insurance company, usually in Texas, because Texas was a state that was very amenable to this type of transaction. The acquisition funds would be borrowed by the holding company from the bank, downstream into the intermediate life insurance/holding company in exchange for a surplus note. Then the intermediate life insurance/holding company would go out and buy the real target. The intermediate holding company and the target would file a life/nonlife consolidated return. There would be a deduction for the interest on the surplus note paid up to the holding company, which would be used against the operating income of the real target—the big life insurance company at the bottom. The interest income on the surplus note at the holding company level would be matched against the bank debt on the outside. What you ended up with at the end of the day was de facto consolidation. You didn't have real consolidation, but you were matching your interest deductions against the income of the operating company.

This ruling was useful in that it basically said that this intermediate holding company would be treated as a life insurance company as long as it met the 50% reserve test and wrote business, even though its real role was to hold the stock of the real target. So it was a very, very useful ruling because it got you by a critical issue, whether you were really an insurance company at all. This ruling got you the right answer. The Service, however, reserved the Section 845 issue, and we'll revisit that in a second.

This ruling (PLR 9228003) was a property and casualty portfolio-loss situation. According to the IRS, there was no tax planning here; this was done with a business purpose in mind. There were tax results that flowed from it, but they were not the purpose of the treaty. The Service didn't care, however, and disallowed the treaty under Section 845(b) because the tax benefits, the Service thought, were disproportionate to the risk transferred.

The lesson of this ruling is that the IRS will try to apply Section 845(b) in the complete absence of tax planning. If the results are favorable from a tax point of view, you have to understand that the Service may try to apply Section 845, even though there's a valid business purpose for the treaty. So this is really an *in terrorem* kind of ruling.

The one case that seems to be pending in the tax court at this point under Section 845 is Lone Star. There were three or four filed, but our latest research indicated that most of them have been settled out, and Lone Star is the only one that is still pending. The reason I mention this was Lone Star involved one of those Texas holding companies. They used related-party reinsurance in the first year to turn the

company into a life company. In the second year they had related- and unrelated-party reinsurance. In the third year they had related party, unrelated party and some direct business. The Service alleged that in all of those years, Lone Star was not a life insurance company; the first year they came under Section 845(a), and in the second and third years fell under Section 845(b).

The primary lesson in Lone Star is that if you are going to use this acquisition structure (and it is still used on occasion), don't use related-party reinsurance. In the early generation of these deals, people would just "life" the holding company by reinsuring the target. That is a serious, serious error. You're going to lose on that one. The second approach is to reinsure some unrelated, third-party business. You're probably going to win on that one, I think, after Trans City Life. If you're in this structure and a lot of money turns on the structure, the smartest thing to do is write some direct business. That's the only way to be sure on this part. Stay away from reinsurance.

Ms. Wallace: The first thing I'd like to say is just a quick word on acting as an expert witness in some of these cases. It's been quite an experience. It's one of the most stressful things I've ever done, as well as one of the most satisfying. To be able to teach somebody who really doesn't have a clue about what we do is really an interesting challenge. I encourage all of you, if you have the opportunity, to seriously consider it.

Let's quickly finish up on the Trans City case and Section 845. I want to give you some of my ideas about the implications of the Section 845 decision in actually doing our work. What does it imply for putting together reinsurance transactions? The Service may ultimately soften the benefit of some of the Trans City decisions, and we have to be conscious of that. But for now, I think it gives us a lot of freedom in our transactions that we didn't have before. First, an arm's length reinsurance transaction that has tax planning as one of its goals is not inherently tax avoidance. That was very clearly stated in the decision. So, it's OK to think about taxes when you're putting together transactions. Second, a ceding commission was very definitely found to be a deductible business expense. That was a very good result. Third, the decision discusses all of the modern treaty devices that we use to meet the economic goals of the parties. They, in and of themselves, do not eliminate risk transfer. These include experience refunds, funds-withheld provisions, risk-fee limitations on the sharing of profits, and recapture provisions—all of these things that some unsophisticated minds believe eliminate risk transfer. That's great news. Finally, the most important thing is the measure of risk transfer.

In Trans City, the government tried to declare that the measure of risk transfer is the probability of the reinsurer losing money. If the reinsurer is certain to lose money, then obviously there has been risk transfer. But if the reinsurer, in retrospect, doesn't lose money, then obviously there wasn't any risk transfer. We know that's not true, but it's a seductive concept for someone who's not really familiar with insurance and reinsurance. Instead, what was proven in Trans City is that it's not the probability of losing money that matters in risk transfer, but the exposure to loss. We all insure our houses, but that doesn't mean we expect the insurance company is going to lose money. We don't expect the house to burn down. Likewise an insurance company buys reinsurance, not because it expects it will lose money, but because it wants protection in the unlikely probability that it will happen.

The judge really understood this and described the measure of risk transfer as exposure to loss. In this case, covering life insurance—the exposure to loss—is the face amount. This dwarfs any tax benefits when we're measuring the risk transfer against the tax benefits received. There's a little bit of a challenge ahead of us in using that same philosophy to measure risk transfer on, say, an annuity business or health insurance business. In an annuity, for example, the exposure to loss is an investment risk. It could be theoretically the full amount of the account value if all assets are wiped out. We have to focus on the exposure to loss; I think that was the real key implication of Trans City.

Also I want to quickly mention three other court cases involving reinsurance. I have been involved in some way in all of these cases, but what I'm going to tell you about is public information. I also don't want to imply any judgment on the quality of the reinsurance involved in these cases, but simply use the knowledge from the cases to help us design better reinsurance transactions in the future.

The first one I'll start with is Executive Life. That was the first big, life company insolvency in the modern era with a lot of reinsurance in force at the point of receivership. Many of those reinsurance contracts involved transactions where the reinsurer had provided letters of credit to Executive Life. There was a big fear that the receivers would draw down those letters of credit, so there was a lot of attention paid to the reinsurance in that insolvency. John Garamendi, the Commissioner at the time in California, very publicly said that he would vigorously pursue claims against any person or company that had ripped off Executive Life. I believe he certainly placed Executive Life's reinsurer in that category. The dealings with the reinsurer actually never ended up going to litigation. It was proposed to the reinsurer (and most of them accepted) that the reinsurance agreements in force be rescinded by both parties *ab initio*. They were, by contract, declared never to have existed. In exchange, the reinsurer returned to the receiver all the profits that they had made during the life of those reinsurance agreements. In consideration of the

return of those fees, the receiver released and discharged the reinsurer from any further action or cause.

From the Floor: Does that include the agent reinsurance companies?

Ms. Wallace: I don't know about the agent reinsurance companies, so this discussion does not include those. I'm not sure what happened there.

On the financial reinsurance in force, all back accounting was just ignored and it was calculated based on how much risk fees the reinsurer got and they returned them. Not every reinsurer agreed to this, but basically that's what happened. That was not a great result for the reinsurer, but it wasn't terribly onerous either. That was sort of the beginning of the trend of going after the reinsurer in the financial reinsurance business.

Next comes First Capital. A slightly different tactic was taken. The injured parties, which included creditors, shareholders and receivers, decided not to go after the reinsurer. Instead, they went after the substantial owner of First Capital, which was Shearson. Shearson was not a 100% owner, but they were a substantial owner. It was claimed that Shearson's holding company violated its fiduciary duties to the injured parties by failing to manage First Capital properly. Examples of this improper management included: allowing First Capital to hoodwink state regulators and violate insurance laws through the use of creative bookkeeping by relying on millions of dollars of improper reinsurance credits. They said that Shearson shouldn't have let its partial subsidiary, First Capital, arrange this improper reinsurance. Therefore, Shearson should be responsible for paying everybody's losses, because Shearson did nothing to stop the mismanagement and improper use of reinsurance credits. Further, under Shearson's oversight, First Capital Holding officers and directors destroyed the company. In court it was shown that First Capital made repeated attempts to satisfy the insurance department, and that it believed it was in compliance with all regulations.

For the most part, these cases were settled to avoid massive litigation expenses, so we don't really have a precedent. What I want to point out to you is the tactic of blaming management for imprudently using reinsurance. So the lesson is that we have to be careful, as I believe most people in this business are, that we're doing the prudent thing when we're arranging reinsurance transactions.

I will move on to the final case I want to discuss—InterAmerican. This is an insolvent Illinois company. The cases on reinsurance are still pending in the courts, and there are some very important implications of the decisions that will be made. InterAmerican was put into liquidation and, as is common, the policies of the

company were transferred to another solvent insurance company along with assets from the Guaranty Fund. This new insurance company is now collecting premiums from and paying claims to the policyholders. Policyholders are whole. However, the financial reinsurance treaties were not moved, although the excess yearly renewable term treaties were moved with the block to the new insurer. The receiver kept ownership of the financial reinsurance treaties in the estate of InterAmerican without any business attached to them. They came up with a very novel argument that will, if they win, require the reinsurer to make up the hole. This is true even though they are granting the right of offset, unlike in the American Standard Life case.

They have said that by virtue of the insolvency, InterAmerican breached its contract with the policyholders. Through that breach, the value of all future claims those policyholders might have should vest at the moment of insolvency. Then they decided to value those benefits at an amount equal to the full statutory reserve at the date of liquidation. The reinsurance agreement says that the reinsurer has to reimburse all benefits that are due the policyholder; therefore, the receiver claims that the reinsurer owes the full value or the present value of future claims effective on the day of insolvency. But as of the date of liquidation, the contract is terminated, so neither has to perform any more under the contract. So the argument says that the reinsurer owes all the claims equal to the statutory reserve. They're given an offset equal to the modified co-insurance reserve, so on a combination co-insurance/modified co-insurance treaty, the reinsurer owes the co-insurance reserve (the amount of the relief).

This is a very dangerous situation for two reasons. The first is the claim valuation methodology. The real economic value of the present value of future claims is not the statutory reserve; it's much less. It's actually equal to the modified co-insurance reserve in most co-insurance/modified co-insurance treaties, or else the reinsurance wouldn't have been done. The second is the status of a reinsurance contract at liquidation. This would be a very bad result if it is upheld. So this case is a very important one. We need to keep our eye on it and help out. Incidentally, most of the reinsurers have settled, but there are two reinsurers still fighting this battle and we've got to help them.

From the Floor: What kind of settlement, not necessarily in terms of dollars, does this line of reasoning imply?

Ms. Wallace: That's not public information.

From the Floor: I have to assume that one of the arguments the reinsurers are using is that the book of business was moved away from the insolvent company, and the policies are still performing as they should.