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IRS CONCLUDES IN CCA THAT SECTION 197 APPLIES TO ALL SECTION 1060 INDEMNITY REINSURANCE TRANSACTIONS

By Lori J. Jones

In an interesting start to the new year, the Internal Revenue Service (IRS) released guidance which concluded that section 197[1] requires the capitalization and amortization of a ceding commission in excess of the amount capitalized under section 848 in "any" section 1060 transaction involving an insurance business. Section 197(f)(5) provides rules to determine the amount of an amortizable section 197 intangible resulting from an assumption reinsurance transaction. In Chief Counsel Advice (CCA) 201501011 (Sept. 4, 2014), the IRS concluded that section 197 applies to a ceding commission regardless of whether the transfer of the insurance business occurs pursuant to an underlying assumption reinsurance or indemnity reinsurance transaction. When the regulations under sections 338 and 1060 were being finalized in 2006, commentators asked for clarification that a ceding commission is deductible under section 848(g) in an indemnity reinsurance transaction even if the overall transaction is subject to section 1060. The clarification was not made and no explicit clarification (supporting either conclusion) was included at that time.[2] It is unfortunate that the guidance on this significant issue is being offered by the IRS only in the form of a CCA. Moreover, the analysis set forth in the CCA raises questions as to its validity.

Summary of Facts

In the CCA, the parties entered into a Master Asset Purchase Agreement (Agreement) whereby Taxpayer purchased certain assets used in Seller's life reinsurance business, including workforce in place and certain fixed assets. The parties also entered into a retrocession agreement for a specified number of Seller's life reinsurance contracts. The Agreement recital provided that Taxpayer wished to assume this portion of Seller's business on a 100-percent coinsurance indemnity basis and that Seller also would enter into an Assumption Agreement whereby Seller agreed to use commercially reasonable efforts to ensure that Taxpayer assumed, on a novation basis, each of the life reinsurance agreements. The facts state that, by Date 2, a certain percentage of the retroceded contracts had been novated to Taxpayer, and, by Date 3, all of the contracts were novated. The actual dates and their proximity in time are not identified in the redacted version of the CCA.

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Taxpayer treated the transaction as indemnity reinsurance under SSAP 61 and stated that the transaction was a section 1060 applicable asset acquisition. For federal income tax purposes, Taxpayer deducted the amount of the ceding commission in excess of the amount capitalized under section 848 because in Tax Year 1 Seller remained liable to the original ceding companies. None of the novations were completed before Date 4. (This suggests that Date 4 is before Date 2.) Consequently, in that case, Taxpayer argued that section 197(f)(5) did not apply and the ceding commission in excess of the amount required to be capitalized under section 848 was fully deductible under section 848(g) (which provides that no rule other than section 848 or 197 requires the capitalization of any ceding commission).

The IRS relied on two arguments to support its conclusion. The first was that the overall transaction was in substance an assumption reinsurance agreement to which section 197 applied even though it was initially structured as an indemnity reinsurance agreement. The second was that section 197 requires capitalization of any ceding commission without regard to whether the underlying reinsurance itself is assumption or indemnity reinsurance if the overall transaction qualifies under section 1060, i.e., there is reinsurance as well as an applicable asset acquisition.[3]

CCA: The Transaction Should Be Treated as Assumption Reinsurance

The IRS noted that, even though the Agreement recital supported Taxpayer's position that the retrocession was on a 100-percent indemnity coinsurance basis, the contract as a whole included language of an assumption reinsurance agreement. As a result, the CCA held that there were sufficient facts to conclude the Agreement was an "assumption retrocession" contract.[4] The IRS relied on the fact that the Entire Agreement

CONTINUED ON **PAGE 44**

incorporated the Assumption and Novation Agreements and the Agreement indicated Seller's intent to sell and exit the life reinsurance business.

Treas. Reg. § 1.197-2(g)(5) contains rules on the treatment of certain insurance contracts acquired in an assumption reinsurance transaction. The regulations apply to:

- assumption reinsurance which is defined in Treas. Reg. § 1.809-5(a)(7)(ii) as, "an arrangement whereby another person (the reinsurer) becomes solely liable to the policyholders on the contracts transferred by the taxpayer. Such term does not include indemnity reinsurance or reinsurance ceded (as defined in paragraph (a)(1)(iii) of section 1.809-4);"

- the transfer of insurance or annuity contracts and the assumption of related liabilities deemed to occur by reason of a section 338 election for a target insurance company which is treated as an assumption reinsurance transaction; and

- the transfer of a reinsurance contract by a reinsurer (transferor) to another reinsurer (acquirer) that is treated as an assumption reinsurance transaction if the transferor's obligations are extinguished as a result of the transaction.

In the CCA, at the time the ceding commission was paid, the relevant agreement was the indemnity reinsurance agreement and Seller had continuing obligations to the ceding companies.

By treating the overall transaction as an assumption reinsurance agreement subject to section 197(f)(5) in Year 1, the IRS appears to rely on the step-transaction doctrine. No authority is cited in the CCA. The IRS could have relied on the last category in the regulation described above, i.e., 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, since it treated all parts of the transaction as one.

In the context of retrocessions, the CCA's application of the step-transaction doctrine may have some merit where extinguishments of the original ceding company's obligations to the direct writer are forthcoming and previously negotiated. Extension of the CCA's analysis to indemnity reinsurance where approval of policyholders to a novation of the direct writer's obligation is required would be troublesome and result in uncertainty without further guidance. It is difficult to see how the step-transaction doctrine can apply where the second step (contract novation) is dependent on multiple third-party consents.

CCA: Section 197 Applies to Indemnity Reinsurance in a Section 1060 Transaction

The more troubling analysis is the conclusion that section 197 applies to any section 1060 transaction even if the underlying reinsurance is indemnity reinsurance. The IRS appears to be adopting a much broader approach to the application of section 197(f)(5) and one which is outside the authority of both the statute and the regulations.[5] The CCA states that Taxpayer failed to address why the regulations under sections 1060, 338 and 197 did not apply to the transaction. It then states that, "If they do, whether Taxpayer entered an assumption or indemnity arrangement with Seller does not determine how it treats the ceding commission for federal income tax purposes (and precludes consideration of whether Arrangement is an assumption or indemnity retrocession contract)." The CCA further concludes that it is "clear" in the residual method rules that an indemnity reinsurance contract is a Class VI asset, section 197 intangible, and it is "clear" the residual method rules treat section 338 and 1060 acquisitions as deemed assumption reinsurance arrangements. The CCA then concludes that, because the section 338 regulations treat the deemed sale of insurance contracts as an assumption reinsurance transaction for federal income tax purposes, and the regulations apply to section 1060 acquisitions, a "section 1060 acquisition is likewise treated as an assumption reinsurance transaction." In conclusion, the CCA holds that Taxpayer must capitalize under section 197 the portion of the ceding commission in excess of the amount capitalized under the DAC provisions.

The IRS' conclusion ignores the basic reason for the limitation of section 197(f)(5) to assumption reinsurance transactions in the first place. An assumption reinsurance transaction results in the transfer of all the value of an intangible asset—the insurance in force. Thus, it makes sense to amortize any ceding commission paid in an assumption reinsurance transaction pursuant to section 197(f)(5). In contrast, an indemnity reinsurance transaction typically is not a permanent transfer of the same intangible asset. Instead, the intangible asset acquired by the reinsurer is merely the contractual rights under the reinsurance contract. The different nature of the intangible asset acquired is reflected by the fact that the direct obligation to

the policyholders remains with the ceding company whereas that obligation is extinguished in the context of assumption reinsurance, and the indemnity reinsurance agreement often contains recapture provisions that allow the agreement to be terminated, thus having the effect of transferring the business back to the ceding company.

The general rule in Treas. Reg. § 1.197-2(g)(5)(i) (set forth above) contains no cross-reference to the section 1060 regulations. In fact, by referring to the definition of assumption reinsurance in Treas. Reg. § 1.809-5(a)(7)(ii), the section 197 regulations exclude indemnity reinsurance from the scope of section 197(f)(5) with no mention of the exclusion being limited to those ceding commissions that are *not* acquired or paid in connection with a transaction to which the section 1060 allocation rules apply. Further, the reference in the section 197 regulations to an acquisition in connection with a section 338 election should not be read to include transactions which do not involve an actual section 338 election such as those subject to section 1060. The CCA makes the puzzling suggestion that the legislative history to section 197(f)(5) expresses a Congressional intent that indemnity reinsurance acquired in a section 338 asset acquisition could be a section 197 intangible. It is difficult to see how indemnity reinsurance would be used in a section 338 fictional deemed asset sale.

Moreover, section 1060 contains special allocation rules for certain asset acquisitions and Treas. Reg. § 1.1060-1(c) only provides a rule for the allocation of consideration among assets. Treas. Reg. § 1.1060-1(c)(5) applies to the acquisition under section 1060 of an insurance business and states that the section 1060 rules are modified by the principles of § 1.338-11(a) through (d) (which provide that if a target is an insurance company, the deemed sale of insurance contracts is treated for Federal income tax purposes as an assumption reinsurance transaction.) These principles apply only in the context of section 1060 for purposes of determining the amount allocable to the insurance contracts and do not govern whether section 197 applies to the overall transaction.

The reference to the section 338 regulations in Treas. Reg. § 1.1060-1(c)(5) only applies to determine the proper allocation of consideration among the acquired assets and does not address whether any portion of the ceding commission is subject to section 197, as assumed in the CCA. Section 197(f)(5) requires capitalization in the case of assumption reinsurance transactions. Treas. Reg. § 1.197-2(g)(5)(ii)(B) states that the amount paid or incurred by a reinsurer *under an assumption reinsurance transaction* includes the amount allocated under section 1060. Thus, section 197 and the regulations require that the transaction be an assumption reinsurance transaction first. This is consistent with the statement in the Notice of Proposed Rulemaking that added Treas. Reg. § 1.1060-1(c)(5) which stated: "the rules in the proposed regulations under section 197 also apply to reinsurers of insurance business in transactions governed by section 1060 if effected through assumption reinsurance." REG-118861-00 (Mar. 8, 2002), 2002-1 C.B. 651.

Finally, contrary to the CCA's assertion, it is not clear that a Class VI asset is always a section 197 intangible. Treas. Reg. § 1.338-6(b)(2)(vi) states that Class VI assets are "all section 197 intangibles, as defined in section 197, except goodwill and going concern value." Treas. Reg. § 1.1060-1(c)(5) implicitly provides an exception to this rule and states that, "…in transactions governed by section 1060, such principles apply even if the transfer of the trade or business is effected in whole or in part through indemnity reinsurance rather than assumption reinsurance, and, for the insurer or reinsurer, an insurance contract (including an annuity or reinsurance contract) is a Class VI asset *regardless of whether it is a section 197 intangible."* (Emphasis added). This language only makes sense if it is possible that the ceding commission in a section 1060 indemnity reinsurance transaction may not always be a payment for a section 197 intangible. Second, the CCA is incorrect in stating it is "clear" that the residual method rules treat section 338 and 1060 transactions as deemed assumption reinsurance arrangements for all purposes. As noted above, the application of the deemed assumption reinsurance rules only affects the allocation of consideration among assets under section 1060. The CCA is not relying on either section 848 or 197 to impose capitalization, but rather on section 1060—a questionable conclusion.

In conclusion, the CCA raises numerous questions as to whether it is appropriate to capitalize a ceding commission under section 197(f)(5) in the context of an indemnity reinsurance transaction merely because the transaction is otherwise subject to section 1060. ◂

CONTINUED ON **PAGE 46**

END NOTES

[1] References to section are to sections of the Internal Revenue Code of 1986, as amended, unless otherwise indicated.

[2] The preamble states that, "Commentators asked that the final regulations clarify that the full amount of consideration allocable to the reinsured contracts is currently deductible under section 848(g) when the provisions of section 848 apply to an indemnity reinsurance transaction that occurs as part of a section 1060 acquisition of an insurance business." T.D. 9257 (April 10, 2006).

[3] Treas. Reg. § 1.1060-1(b)(9) states that, "The mere reinsurance of insurance contracts by an insurance company is not an applicable asset acquisition, even if it enables the reinsurer to establish a customer relationship with the owners of the reinsured contracts. However, a transfer of an insurance business is an applicable asset acquisition if the purchaser acquires significant business assets, in addition to insurance contracts, to which goodwill and going concern value could attach. For rules regarding the treatment of an applicable asset acquisition of an insurance business, see paragraph (c)(5) of this section."

[4] The CCA includes a footnote which states that the IRS position is that a retrocession agreement is treated as reinsurance citing Rev. Rul. 2008-15, 2008-1 C.B. 633, but noting the contrary conclusion in *Validus Reinsurance, Ltd. v. U.S.*, 19 F. Supp. 3d 225 (D.D.C. 2014) 2014-1 U.S. Tax Cas. (CCH) P70 325.

[5] The 1993 legislative history to section 197(f)(5) states as follows: The bill applies to any insurance contract that is acquired from another person through an *assumption reinsurance transaction (but not through an indemnity reinsurance transaction)*. The amount taken into account as the adjusted basis of such a section 197 intangible, however, is to equal the excess of (1) the amount paid or incurred by the acquirer/reinsurer under *the assumption reinsurance transaction*, over (2) the amount of the specified policy acquisition expenses (as determined under section 848 of the Code) that is attributable to premiums received under *the assumption reinsurance transaction.* The amount of the specified policy acquisition expenses of an insurance company that is attributable to premiums received under an *assumption reinsurance transaction* is to be amortized over the period specified in section 848 of the Code. H.R. Rep. No. 103-213, at 687-88 (1993) (Conf. Rep.) *Assumption reinsurance* as defined in the legislative history is, "An assumption reinsurance transaction is an arrangement whereby one insurance company (the reinsurer) becomes solely liable to policyholders on contracts transferred by another insurance company (the ceding company). In addition, for purposes of the bill, an *assumption reinsurance transaction* is to include any acquisition of an insurance contract that is treated as occurring by reason of an election under section 338 of the Code." (Emphasis added.) H.R. Rep. No. 103-213, at 974 n. 125 (1993) (Conf. Rep).

TWO PLRs PROVIDE SOME CLARITY ON SECTION 351 AND INDEMNITY REINSURANCE

By Lori J. Jones

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Twenty years after the Internal Revenue Service (IRS) changed its position on the application of section 351 to assumption reinsurance transactions in Rev. Rul. 94-45, 1994-2 C.B. 39, through the issuance of two private letter rulings, we have some clarity on the corollary question of whether section 351 can also apply to indemnity reinsurance transactions even if novations are not expected as part of the overall transaction. The bottom line is that, if the indemnity reinsurance transaction is of a permanent nature, the IRS has concluded that section 351 can apply so that the ceding commission is not subject to tax pursuant to subchapter L (assuming all of the other section 351 requirements are satisfied). However, if the indemnity reinsurance agreement permits recapture by the ceding company or includes profit sharing provisions, the principles of subchapter L will apply to determine the proper tax treatment of the arm's length reinsurance portion of the transaction.

Section 351 provides that no gain or loss is recognized if property is transferred to a corporation by one or more persons solely in exchange for stock and immediately after the exchange such person(s) are in control of the corporation. In Rev. Rul. 94-45, the IRS held that the transfer of assets to a subsidiary which included the transfer of the insurance business via assumption reinsurance was tax-free under section 351. In that case, the ceding company was not subject to tax on the transfer of the insurance in force which was included in the value of the stock received in the exchange. If the reinsurance portion of the transfer is carved out of the section 351 transaction and treated as a taxable transaction, the results can be very different (e.g., increases/decreases in tax reserves, DAC, etc.)

PLR 201506008

In February, the IRS released PLR 201506008 (Oct. 21, 2014), which applied section 351 to an indemnity reinsurance transaction that the IRS stated was anticipated to result in a permanent transfer. (The ruling initially had been submitted to the IRS in June 2012, and, therefore, was not subject to the restrictions on section 351 rulings initially imposed by the Corporate Division in Rev. Proc. 2013-32, 2013-28 I.R.B. 55.) The proposed transaction involved the transfer of assets to a newly acquired dormant shell insurance company (Corporation C). Corporation C will be owned by newly formed Partnership B

(an LLC), which will in turn be owned by Partnership A (also an LLC). Partnership A also owns Corporation A, an insurance company for federal income tax purposes that operates as a direct writer and reinsurer of dental, life and health insurance contracts in most states. Partnership A was formed to provide a joint venture for Branded Insurers and their subsidiaries and to combine certain components of their dental, life and health business.

In the transaction, Partnership A will form Partnership B and Partnership B will acquire the stock of Corporation C. Partnership A will then contribute cash, and Corporation A and New Investors (who will acquire an interest in Partnership A) will contribute a certain percentage of their Specified Line of Business, to Corporation C solely in exchange for stock. Specifically, the contribution by Corporation A and New Investors will include insurance in force via reinsurance contracts, and a contract transferring the rights to perform administrative services for the business currently managed by New Investors (New ASC). Also in exchange for stock, Corporation A and the New Investors will contribute all existing unpaid Specified Line of Business liabilities (i.e., claims and IBNR liabilities) and related assets. The transferred assets will include cash, investment assets, and premium receivables, as well as the right to then future results of the future insurance policies for existing and future customers of Corporation A and New Investors. Corporation A also will transfer employees to Corporation C to perform certain functions relating to the business. After the contributions and pursuant to a pre-existing binding plan, Partnership A, Corporation A, and New Investors will contribute their Corporation C stock to Partnership B in exchange for Partnership B units.

The PLR also states that the transfer of the Specified Line of Business will be effected by a "100 percent coinsurance agreement written on an indemnity basis, with automatic reinsurance on new policies directly written on a going forward basis." The PLR specifically states:

> The reinsurance agreement will only be in exchange for a transfer of Corporation C shares, which represent a long-term continuing interest in Corporation C. There will be no experience rated refunds or profit sharing provisions to the reinsurance agreement. Should Corporation A or New Investors decide to withdraw from the joint venture, they would be required to purchase the Specified Line of Business it contributed back from Corporation C at fair market value including a gross up for taxes. **As a result, it is anticipated that the transfer under the reinsurance agreement will be permanent.** (Emphasis added.)

The New Investors will retain the actual subscriber, provider and underlying administrative services contracts and operate on a fronting basis via the indemnity reinsurance. It is also anticipated that Corporation C will operate via a transitional services agreement with New Investors until Corporation C has the infrastructure to manage the administration of the insurance business.

The IRS concluded that the transfer of assets by the Corporation C shareholders, including reinsurance contracts and new ASC, in exchange for Corporation C stock, constitutes a transfer of property to a controlled corporation meeting the requirements of section 351. Consequently, the IRS ruled that no gain or loss will be recognized by the shareholders on the transfer of the assets, including the Specified Line of Business, in exchange for stock. The IRS did not cite Rev. Rul. 94-45 as support for their conclusions.[2] It did require several typical representations from the taxpayer, including a representation that a portion of the fair market value of the stock to be issued is allocable to the value of the insurance in force and that Corporation C would be solvent immediately after the contributions. Similarly, the taxpayer represented that the total fair market value of the transferred assets will exceed the amount of any liabilities assumed (within the meaning of section 357(d) and taking into account the application of Rev. Rul. 80-323, 1980-2 C.B. 124) by Corporation C in connection with the exchange. (Rev. Rul. 80-323 holds that each partnership interest exchanged for Newco stock will be transferred subject to its share of partnership liabilities and gain will be recognized to the extent that each partner's share exceeds the adjusted basis of the interest transferred.) Most other representations were those required by Rev. Proc. 83-59, 1983-2 C.B. 575, which are/were applicable to section 351 transactions in general.

PLR 201511015

The IRS reached a different conclusion in PLR 201511015 (Nov. 14, 2014), where it held that the tax treatment of the transfer of assets and liabilities in the arm's-length reinsurance portion of a proposed transaction would be determined in accordance with the provisions of subchapter L applicable to indemnity reinsurance. (By contrast to PLR 201506008, this PLR was subject to the restrictions in Rev. Proc. 2013-32, *supra.*) The IRS also stated that the application of subchapter

CONTINUED ON **PAGE 48**

L to the reinsurance portion did not preclude the transfer of other assets in excess of the arm's-length reinsurance portion of the proposed transaction from qualifying under section 351. Thus, the IRS appeared to take the same approach here that it took in PLR 201006002 (Nov. 6, 2009) (where the arm's-length transfer of assets and liabilities in an indemnity reinsurance transaction were not subject to section 351, but the transfer of additional assets did qualify for section 351 treatment).

The proposed transaction in PLR 201511015 involves a Parent corporation that was the common parent of a life/nonlife consolidated return which includes LifeCo, a life insurance company for federal income tax purposes. LifeCo had previously demutualized and became a stock company now owned indirectly by Parent. Certain LifeCo policies in force at the time of its demutualization became a closed block of contracts entitled to receive policyholder dividends and LifeCo designated certain assets to support the regulatory closed block of policies (the RCB). The designated RCB assets are not kept in an account separate from LifeCo's other assets.

In the proposed transaction, LifeCo and Sub will enter into a Reinsurance Agreement. Sub will either be a newly formed corporation of LifeCo or an existing wholly owned corporation of LifeCo that is part of the life insurance company subgroup of the Parent consolidated group. LifeCo will transfer capital and surplus as well as assets and liabilities related to the RCB to Sub. It is represented that the fair market value of the assets that will be transferred to Sub will exceed the amount of assets that LifeCo would be required to pay in an arm's-length indemnity reinsurance transaction. The reinsurance transaction is described as follows:

> Pursuant to the Agreement, LifeCo will cede and Sub will assume certain specified liabilities. LifeCo will transfer approximately d percent, which is less than 100 percent, of the insurance risk on the RCB business to Sub by conventional coinsurance on the Effective Date. **Moreover, the Agreement provides LifeCo with recapture rights. At any time, LifeCo may elect to recapture, in full or in part, the reinsurance coverage provided by the Sub. If LifeCo elects to exercise such rights, the Sub is obligated to return any remaining RCB assets to LifeCo.** (Emphasis added.)

Key Differences

It is this last emphasized language in PLR 201511015 that provides a stark contrast to the facts stated in PLR 201506008, and which likely resulted in a different conclusion. Another factual difference is that PLR 201506008 did not involve a transaction between two members of the same consolidated group (as was the case in PLR 201511015). No analysis is provided in either PLR, but the key difference appears to be that in order for the transfer of assets and liabilities in an indemnity reinsurance transaction to qualify under section 351, the transfer must be "permanent." This conclusion is consistent with the IRS view that there is no transfer of intangible property unless all substantial rights in the property are transferred by the transferor corporation. See, e.g., Rev. Rul. 69-156, 1969-1 C.B. 101.[3] The conclusion is also consistent with Treas. Reg. section 1.197-2(g)(5)(iii), which provides guidance on the loss disallowance rule upon a disposition of an insurance contract acquired in an assumption reinsurance transaction. The regulation provides that the loss may be taken as a result of an indemnity reinsurance transaction, "provided that sufficient economic rights relating to the reinsured contracts are transferred to the reinsurer." Treas. Reg. section 1.197-2(g)(5)(iii)(A). The regulation also states that:

> However, the ceding company is not permitted to recover basis in an indemnity reinsurance transaction if it has a right to experience refunds reflecting a significant portion of the future profits on the reinsured contracts … through the exercise of a recapture provision. In addition, the ceding company is not permitted to recover basis in an indemnity reinsurance transaction if the reinsurer assumes only a limited portion of the ceding company's risk relating to the reinsured contracts (excess loss reinsurance).

In PLR 201506008, the taxpayer represented that there will be no experience rated refunds or profit sharing provisions to the reinsurance agreement and that a fair market value purchase price (including a gross up for taxes) would be required should the investors seek to repurchase the transferred business. In contrast, in PLR 201511015, the indemnity reinsurance agreement will provide the ceding company with recapture rights. It is not clear whether the IRS conclusion in PLR 201511015 was also based on the fact that less than 100 percent of the risk was transferred. Such a conclusion might be consistent with the last sentence in Treas. Reg. section 1.197-2(g)(5)(iii)(A)(2), i.e., that the reinsurer assumed only a limited portion of the risk.

Conclusion

The PLRs provide helpful guidance to determine when certain indemnity reinsurance transactions qualify for section 351 treatment. Importantly, however, the PLRs do not address

all of the respective corollary consequences of section 351 treatment (or lack thereof) and do not provide guidance as to when a permanent transaction is effected in all situations. In any case, the guidance is welcome. ◂

END NOTES

[1] In Rev. Rul. 94-45, 1994-2 C.B. 39, the IRS revoked Rev. Rul. 75-382, 1975-2 C.B. 121, which held that section 351 did not apply to the transfer of cash and other assets by a foreign mutual life insurance company to a newly formed domestic life insurance company for all of its stock followed by an assumption reinsurance agreement. Since then, there have been numerous PLRs where the IRS held that section 351 applied to an indemnity reinsurance transaction as long as novations were anticipated as part of the overall transaction. *See, e.g.,* PLR 201232030 (May 10, 2012); PLR 200737012 (June 14, 2007); PLR 200447004 (July 27; 2004), PLR 200109039 (Dec. 4, 2000); PLR 200017002 (May 19, 1999); PLR 9752059 (Sept. 30, 1997); and PLR 9738031 (June 24, 1997). *See also* CCA 201501011 (Sept. 4, 2014), where the IRS took a broad view of assumption reinsurance for purposes of determining whether a ceding commission was subject to capitalization under section 197(f)(5).

[2] Nor did the IRS address the specific consequences of the section 351 transaction with respect to the transfer of assets and liabilities under subchapter L and section 848 (DAC).

[3] *See also E.I. DuPont de Nemours & Co., v. U.S.*, 471 F.2d 1211, 1219 (Cl. Ct. because prior to 1992), where the court agreed with the taxpayer that section 351 applied despite the absence of a sale or exchange, because "although the rights granted were not all the rights under the patents, they were perpetual, irrevocable, and quite substantial in value."

THE OECD'S BASE EROSION AND PROFIT SHIFTING ACTION PLAN: SHOULD INSURANCE COMPANIES CARE?

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Base Erosion and Profit Shifting Project

In February 2013, the Organisation for Economic Co-operation and Development (OECD) released its highly anticipated report on tax base erosion and profit shifting (BEPS).[1] The report was prompted by the perception of certain member countries that international tax rules have fallen behind rapidly changing international business practices, thereby allowing inappropriate BEPS. The BEPS Report was followed in July 2013 by the OECD's release of its action plan for addressing what it saw as gaps in the international tax system due to varying domestic tax regimes, which could lead to BEPS.[2] The BEPS Action Plan enumerates 15 areas of international tax law, practice and procedure for additional focus. These areas range from the tax challenges of the digital economy to developing more effective treaty amendment and dispute resolution processes. Of particular importance to insurance companies are Action 4, Interest Deductions and Other Financial Payments, and Action 13, Guidance on the Implementation of Transfer Pricing Documentation and Country-by-Country Reporting.[3]

Action 4

The OECD's discussion draft on Action 4 reiterates the concern of certain governments that multinational companies can erode their local country tax bases through excessive interest deductions.[4] The draft states that some entities in a multinational group may be excessively leveraged, and parent companies may borrow to invest in assets that generate income that is deferred or exempt for tax purposes. The Action 4 Discussion Draft expresses the OECD view that current local country limitations on interest expense deductions have not been entirely effective in addressing these issues. The draft further states that a consistent approach for rules on the deduction of interest expense would allow multinationals to plan their capital structures with greater confidence (as the risk of unilateral law changes would be minimized), reduce the risk of double taxation (e.g., situations where the creditor is taxed on interest income but the obligor is denied an interest expense deduction), and make it possible to introduce group-wide systems and processes to generate the information required to implement the limitations.

In order to address these concerns, the draft sets forth several alternative approaches to limiting deductions for interest expense. The principal approaches discussed are (1) a group-wide rule, which would limit a company's net interest deductions to a proportion of the group's actual net third-party interest expense; (2) a fixed ratios rule, which would limit a company's interest deductions to an amount determined by applying a fixed benchmark ratio to an entity's earnings, assets or equity; and (3) certain combinations of these two approaches. The Action 4 Discussion Draft also discusses the use of more targeted approaches. It identifies benefits and drawbacks of the approaches considered, as well as key questions raised by each approach.

CONTINUED ON **PAGE 50**

The discussion draft reiterates the OECD's intention to develop recommendations for a best-practice approach or approaches for countries to use in addressing concerns about BEPS through interest expense. This work is scheduled to be completed by late 2015.

The draft begins with a review of existing approaches used by countries to address BEPS concerns with respect to interest expense. The draft then discusses a series of issues that are relevant to any approach for limiting interest deductions, including what constitutes interest or an economically equivalent payment, what entities should be subject to the limitation, whether the limitation should key off debt amounts or interest expense, and whether it should apply on a gross or net basis.

The Action 4 Discussion Draft also discusses a range of technical, policy and industry-sector issues relevant to the consideration of these approaches. The draft specifically notes that "Banks and insurance companies present particular issues that do not arise in other sectors."[5] For example, unlike taxpayers in most other industries, banks and insurance companies will usually be recipients of net interest income, such that a rule capping net (as opposed to gross) interest expense would have no direct impact. In addition, the draft acknowledges that interest expense is much more closely tied to the ability of banks and insurance companies to generate income than for taxpayers in other industries. Finally, the draft notes that banks and insurance companies are already subject to non-tax (regulatory) restrictions on their capital structure.

As a result of these industry-specific considerations, the Action 4 Discussion Draft advocates designing a specific rule that focuses on the particular BEPS risks presented by these companies. The draft presents some examples of such a rule. The first would focus on the net interest expense attributable to regulatory capital instruments. A group-wide allocation rule could limit a group's total deductions on its regulatory capital to the amount of interest expense paid on those instruments to third parties. Within the group, the draft suggests that an interest cap could be allocated based on regulatory requirements, but only if that prevents BEPS. Either of these approaches, however, would be difficult for most insurance companies to apply and could lead to distortive and unintended results (such as a misalignment between regulatory and tax positions). Alternatively, the Action 4 Discussion Draft states that "if existing regulatory requirements act as an effective general interest limitation rule, and prevent excessive leverage in group entities," then a more targeted approach could instead focus on interest expense other than that on regulatory capital.[6] Appropriately drafted, this approach could avoid many of the issues created by attempting to apply a one-size-fits-all group-wide allocation or debt cap rule.[7]

Action 13

The BEPS Report states that in a truly global economy, local country tax administrators have limited visibility to taxpayers' worldwide operations. In the OECD's view, this, in turn, limits the administration of the arm's-length principle and enhances opportunities for BEPS. In addition, the report states that the variations in countries' transfer pricing documentation requirements lead to significant administrative costs for businesses. Action 13 of the BEPS Action Plan proposed to develop rules on transfer pricing documentation to enhance transparency for tax administrators, taking into consideration the compliance costs for business. The primary goal for these rules was to require taxpayers to provide the relevant governments with information on the global allocation of income, economic activity and taxes paid among countries, using a standardized template.

The report released last September on Action 13 contains standards for transfer pricing documentation and a template for extensive country-by-country (CbC) reporting.[8] This was followed by further guidance issued in February and June of this year.[9] They provide that the first CbC reports will be filed for 2016 fiscal years. The CbC reporting template requires multinational enterprises (MNEs) to report the amount of revenue, profits, income tax paid and taxes accrued, employees, stated capital, retained earnings and tangible assets annually for each tax jurisdiction in which they do business. In addition, MNEs are also required to identify each entity within the group doing business in a particular jurisdiction and to provide an indication of the business activities the entity conducts. This information is intended to be shared with tax authorities in all jurisdictions in which the MNE operates.

The guidance on transfer pricing documentation requires MNEs to include a high-level overview of their global business operations and transfer pricing policies in a "master file" that also is to be shared with all relevant-country tax administrators. Specific information would be required

for intangibles and intercompany financial activities. Moreover, the transfer pricing guidance requires that detailed information on all relevant material intercompany transactions be included in a "local file" in each country to be provided to such country's tax administration.

Although the OECD considered compliance costs to taxpayers, the complexity and level of detail required in the CbC template would still create a substantial compliance burden on insurance companies. Moreover, as with the potential one-size-fits-all approaches in Action 4, the CbC template requires extensive information that is simply not relevant and could be misleading in assessing BEPS implications of a multinational insurance group. For example, employees, stated capital and tangible assets in a particular country could easily give a distorted view of the scope and nature of an insurance group's activities in that country. Confidentiality considerations are also raised by the wide access various authorities and persons could have to both the CbC template and master file.[10]

END NOTES

1. Addressing Base Erosion and Profit Shifting (Feb. 12, 2013) *(http://www.oecd.org/tax/addressing-base-erosion-and-profit-shifting-9789264192744-en.htm)* (the "BEPS Report").
2. Action Plan on Base Erosion and Profit Shifting (July 19, 2013) (http://www.oecd.org/ctp/BEPSActionPlan.pdf) (The BEPS Action Plan).
3. The recommendations or "best practices" in the Actions have no legal force unless and until enacted by member countries.
4. On Dec. 18, 2014, the OECD released a discussion draft under Action 4, titled "BEPS Action 4: Interest Deductions and Other Financial Payments" (http://www.oecd.org/ctp/aggressive/discussion-draft-action-4-interest-deductions.pdf) (the Action 4 Discussion Draft).
5. Action 4 Discussion Draft at 62.
6. *Id.* at 63.
7. *See also* Insurance Company Working Group on BEPS Outline of Comments on Action 4 Discussion Draft (Deductibility of Interest), http://www.oecd.org/tax/aggressive/public-comments-action-4-interest-deductions-other-financial-payments-part1.pdf at 527.
8. On Sept. 16, 2014, the OECD released Action 13: Guidance on the Implementation of Transfer Pricing Documentation and Country-by-Country Reporting *(http://www.oecd.org/ctp/beps-action-13-guidance-implementation-tp-documentation-cbc-reporting.pdf)*.
9. *See* http://www.oecd.org/ctp/beps-action-13-guidance-implementation-tp-documentation-cbc-reporting.pdf; http://www.oecd.org/ctp/transfer-pricing/beps-action-13-country-by-country-reporting-implementation-package.pdf.
10. *See also* Transfer Pricing Documentation and Country-by-Country Reporting Comments by The Insurance Company Working Group on BEPS, *http://www.oecd.org/ctp/transfer-pricing/volume2.pdf* at 344.

Note: The views expressed herein are those of the author and do not necessarily reflect the views of Ernst & Young LLP.

SUBCHAPTER L: CAN YOU BELIEVE IT? WITHHOLDING AND REPORTING MAY NOT BE REQUIRED FOR INCOME ON FAILED LIFE INSURANCE CONTRACTS

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A policyholder who owns a contract which is a life insurance contract under applicable law that fails the definition of a life insurance contract in I.R.C. § 7702 is required to treat the income on the contract as ordinary income received or accrued during the taxable year. In general, this income on the failed contract is the amount by which the increase in the net surrender value of the contract plus the cost of insurance exceeds the premiums paid for the year.[1] In Rev. Rul. 91-17,[2] the IRS ruled that the issuer of a failed contract is subject to the withholding and reporting requirements applicable to nonperiodic distributions from life insurance contracts. The ruling also noted that an insurer's failure to comply with these withholding and reporting requirements could result in penalties. Is this ruling correct? Believe it or not, the ruling likely is wrong.

The exclusive support for the IRS's legal conclusion in Rev. Rul. 91-17 is legislative history. The House Committee Report that explains the House bill's version of what was enacted as I.R.C. § 7702 includes the following statement that assumes that withholding and reporting are required on failed contracts:

> Because the income on the contract is treated as received by the policyholder, the income would be a distribution subject to the recordkeeping, reporting, and withholding rules under present law relating to commercial annuities (including life insurance). It is hoped this will provide the policyholder with adequate notice that disqualification has occurred, thus giving some protection against underpayment of estimated taxes.[3]

Substantially the same statement was included in the post-enactment Joint Committee on Taxation staff's "Blue Book."[4] Because it was the House's version of I.R.C. § 7702 that was adopted in the Deficit Reduction Act of 1984,[5] Rev. Rul. 91-17 concludes that the issuer of a failed contract is required

CONTINUED ON **PAGE 52**

to withhold and report with respect to the income on the contract.[6] However, the statement made in the legislative history is inconsistent with the statutory language of the relevant Code provisions. The relevant reporting and withholding provisions are found in I.R.C. § 6047(d) and I.R.C. § 3405. Under I.R.C. § 6047(d), the IRS is granted authority to require information reporting for issuers of contracts "under which designated distributions …may be made." A "designated distribution" subject to withholding is defined in I.R.C. § 3405(e) to include distributions from a "commercial annuity," which, in turn, is defined to include an annuity, endowment or life insurance contract issued by an insurance company licensed to do business under the laws of any State. So far, so good—the IRS can require withholding and reporting on life insurance contracts.

But wait, I.R.C. § 7702(a) says that a life insurance contract under the applicable law is a life insurance contract "[f]or purposes of this title," but only if it satisfies the I.R.C. § 7702 cash value accumulation test or guideline premium requirements. Because the withholding and reporting requirements are in the same title as I.R.C. § 7702—Title 26 of the United States Code—a failed contract cannot be a life insurance contract that can produce a designated distribution that is subject to this kind of withholding and reporting obligation.

Thus, there is a conflict between the plain language of the statute and the statement in the legislative history relied upon in the IRS ruling. Without saying so, the IRS must have concluded in Rev. Rul. 91-17 that the conflict should be resolved by following the legislative history. This conclusion is problematic in light of established rules of statutory construction. The Supreme Court has held repeatedly that legislative history can be used as a guide to statutory construction only when the statute is ambiguous.[7] The only exceptions to this rule are when there is a clearly expressed legislative intent to the contrary that is unequivocal,[8] or when the plain language produces an absurd or unreasonable result.[9] Even then, some courts have held that the plain language of the statute can be overridden only when the absurdity is so gross as to shock common sense.[10] If it were up to him, Justice Scalia probably would not resort to legislative history to override the statute even in these circumstances.[11]

With respect to failed life contracts, the statute is clear and unambiguous that withholding and reporting is not required because these contracts do not qualify as life insurance contracts for purposes of the Code and so are not commercial annuities as defined in I.R.C. § 3405. Although the legislative history assumes that withholding and reporting should be required, it appears to reflect a misunderstanding by the drafters of the definitional intricacies of applicable withholding and reporting provisions that had been enacted previously in 1982 as part of TEFRA.[12] This likely would not be the type of clear reflection of Congress' intent that is necessary to override the plain language of the statute. In fact, the language of I.R.C. § 7702(g)(3) itself reflects a contrary Congressional intent. Specifically, I.R.C. § 7702(g)(3) provides that a failed contract is to be treated as an insurance contract, not a life insurance contract, again, for purposes of the entire title.[13] Thus, the statement in the legislative history contradicts Congress' express statutory direction to the contrary.

As a practical matter, in most cases the questionable validity of Rev. Rul. 91-17 would not change what an insurer does when it discovers that it has issued failed life insurance contracts. Because of potential lawsuits from policyholders, the insurer usually will want to obtain the retroactive IRS protection available with a failed-contract waiver under I.R.C. § 7702(f)(8) or an IRS closing agreement under Rev. Proc. 2008-40,[14] and request such a waiver or a closing agreement from the IRS National Office to reinstate a failed contract's qualification as a life insurance contract. The salient point is that the primary reason to pursue such a waiver or closing agreement is to minimize exposure to policyholder claims and class action lawsuits, not to avoid likely unenforceable IRS impositions of penalties for failure to withhold and report the income on the contract.◂

[1] I.R.C. § 7702(g).

[2] 1991-1 C.B. 190, *superseded in part*, Rev. Proc. 2008-40, 2008-2 C.B. 151.

[3] H.R. Rep. No. 98-432, pt. 2, at 1449 (1984).

[4] Joint Comm. on Taxation, JCS-41-84, *General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984,* at 655 (Dec. 31, 1984).

[5] H.R. Rep. No. 98-861, at 1076 (Conf. Rep. 1984).

[6] The IRS cited Rev. Rul. 91-17 again in Rev. Proc. 2008-40, 2008-2 C.B. 151, Rev. Proc. 2008-42, 2008-2 C.B. 160 and Notice 99-48, 1999-2 C.B. 429.

[7] *Chevron U.S.A. Inc. v. National Resources Defense Council, Inc.,* 467 U.S. 837, 842-43 (1984); *Barnhart v. Sigmon Coal Co., Inc.,* 534 U.S. 438, 460-61 (2002); *Hughes Aircraft Co. v. Jacobson,* 525 U.S. 432, 438 (1999).

[8] *Public Citizen v. U.S. Dept. of Justice*, 491 U.S. 440, 452-53 (1989); *Watt v. Alaska,* 451 U.S. 259, 266 (1981).

[9] United States v. American Trucking Ass'ns, Inc. 310 U.S. 534, 543 (1940); Commissioner v. Brown, 380 U.S. 563, 571 (1965).

[10] *Sigmon Coal Co., Inc. v. Apfel*, 226 F.3d 291, 304 (4th Cir. 2000), aff'd 534 U.S. 438 (2002); *Griffin v. Oceanic Contractors, Inc.,* 458 U.S. 564, 575 (1982).

[11] *Lawson v. FMR, LLC,* 134 S. Ct. 1158 (2014) (Scalia, J., concurring in part); *Graham County Soil and Water Conservation Dist., v. United States,* 559 U.S. 280 (2010) (Scalia, J., concurring in part). This was the thrust of Justice Scalia's dissent in *King v. Burwell,* S. Ct. Dkt. No. 14-114 (Decided June 25, 2015).

[12] Tax Equity and Fiscal Responsibility Act of 1982, Pub. L. No. 97-248 § 334(a) (1982).

[13] A peer reviewer of an earlier draft of this column pointed out that I had not discussed any actual provision of **Subchapter L** of the Code (which does not include I.R.C. § 3504, 6047 or 7702) even though my regular column is entitled "Subchapter L: Can You Believe It." So, here goes. Because a failed life insurance contract is treated as insurance for all tax purposes, under Subchapter L the premiums are included in gross income and a deduction for tax reserves is allowable. The legislative history suggests that the investment portion of the contract is treated as a reserve under I.R.C. § 807(c)(4). H. R. Rep. No. 98-432 (Pt. 2) 1413 n.10 (1984). Presumably an additional unearned premium reserve also is deductible for the insurance portion of the contract.

[14] 2008-2 C.B. 151.