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CONSEQUENCES OF INSURANCE BUSINESS OR COMPANY ACQUISITIONS

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***Editor's Note:** The objective of this "In the Beginning …" piece is to provide some explanatory background, including a helpful numerical example, regarding the primary tax provisions that are the subject of Chief Counsel's Advice (CCA) 201501011 (Sept. 4, 2014). The CCA is also discussed in this edition's "Taxing Times Tidbits," in "IRS Concludes in CCA that Section 197 Applies to All Section 1060 Indemnity Reinsurance Transactions" by Lori J. Jones, page 43.*

A buyer wanting to purchase a business can generally do so by purchasing either stock of a target company (Target) from its shareholder or the assets of the Target directly from the Target. The difference between these acquisition alternatives from a federal income tax standpoint is whether the buyer will have a fair market value basis in the stock of the Target or in the assets of the Target, since it only receives a fair market value basis for tax purposes in what it purchases. The amount of basis a buyer has in its assets is important, since the basis, along with the amount received on a subsequent sale of the assets, will impact the amount of taxable gain or loss on such subsequent sale.

To illustrate this point, assume that a buyer pays $10 to acquire the assets of a Target and that the Target has an $8 tax basis in its assets. If the buyer acquires the Target's stock, the buyer will be entitled to a tax basis in the Target's assets of $8. If the buyer instead acquired the Target's assets directly, it would be entitled to a $10 basis in the assets. If the buyer were to subsequently sell the Target's assets for the same $10 amount it paid, the buyer would be required to recognize a $2 taxable gain if it had purchased the Target's stock. If it had acquired the assets directly, it would not have had to recognize any taxable gain on the subsequent sale of the assets.

From the seller's perspective, the amount of gain or loss it would recognize in a sale of stock is not necessarily equivalent to the amount of gain or loss that the Target would recognize in an asset sale. This is because the amount of such gain or loss depends on the seller's basis in the Target's shares and the Target's basis in its assets, which are often different amounts in the aggregate. Following the example above, if the purchase price is $10, the seller has a $5 tax basis in the Target's stock, and the Target has an $8 tax basis in its assets, a stock sale would generate a $5 gain while an asset sale would generate only a $2 gain.[2]

SECTION 338 AND 1060 TRANSACTIONS GENERALLY

If certain requirements are met, the buyer and seller may be able to elect to treat what is in form a stock purchase as an asset purchase for federal income tax purposes. This can benefit one or both of the parties by eliminating any stock gain and providing both the buyer with a fair market value in the Target's stock and the Target with a fair market value basis in its assets. Specifically, a buyer may purchase the stock of a company and elect under section 338[3] to treat the stock purchase as a hypothetical asset purchase between an "old" Target and a fictional "new" Target followed by a deemed liquidation of the "old" Target.[4] Where a section 338 election is made, a residual allocation approach is applied to determine the amount of gain to be recognized and the Target's resulting basis in its assets. In this regard, the seller's aggregate deemed sales price (ADSP) and the purchaser's adjusted grossed-up basis (AGUB) (generally the amount paid for the Target's shares plus the Target's liabilities) are allocated among the transferred assets using a tiered approach that is generally referred to as a "residual allocation" methodology.[5] Pursuant to section 1060, this methodology also applies to asset acquisitions in which goodwill or going concern value could attach to the acquired assets. This is normally the case where customer lists or relationships or a workforce in place is acquired as part of an asset acquisition.

The residual allocation methodology utilizes seven classes, beginning with cash (Class I) and ending with what are referred to as section 197 intangibles (Class VI) and a residual category called "goodwill and going concern value" (Class

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VII). The classes to which ADSP and AGUB are allocated are significant because they impact the amount and character of the gain or loss recognized in the sale and the Target's future amortization of that basis in the buyer's hands. For example, section 197 intangibles are generally subject to a uniform 15-year amortization period while amortizable property in other classes may be subject to a shorter or longer amortization period.

SECTION 338 AND 1060 TRANSACTIONS IN THE INSURANCE CONTEXT

Unlike the purchase and sale of a non-insurance company, if the stock of an insurance company is purchased in a transaction for which the buyer and seller are eligible to make a section 338 election and such election is made, it gives rise to a fictional asset sale as well as a fictional assumption reinsurance transaction[6] between the old Target and a new Target, followed by a deemed liquidation of the old Target into its selling shareholder.[7] This is different from non-insurance company acquisitions because insurance companies have current and future obligations under insurance policies that must be transferred in what is referred to as a reinsurance transaction. A reinsurance transaction itself gives rise to tax consequences that are not present in the case of a normal asset sale.

Pursuant to regulations issued under section 338, the old Target in the fictional assumption reinsurance transaction is deemed to pay a gross amount of premium equal to the amount of the old Target's tax reserves[8] for the acquired insurance contracts and is also deemed to receive a ceding commission in an amount equal to any portion of the ADSP allocated to the acquired contracts under the residual allocation method described in the regulations under section 338.[9]

The direct acquisition of an insurance business, whether through assumption or indemnity reinsurance, is governed by section 1060 of the Code if significant business assets are acquired to which goodwill or going concern value could attach.[10] The significance of section 1060 applying to such a direct acquisition of an insurance business is that it gives rise to US federal income tax consequences similar to a stock purchase accompanied by a section 338 election, as described and illustrated above.

Consistent with a normal section 338 or section 1060 transaction, the seller (i.e., old Target) allocates the ADSP and the buyer (i.e., new Target) allocates the AGUB among the transferred assets under the residual allocation method.[11] However, special rules apply to the actual or deemed assumption reinsurance transaction that occurs in a section 338 or 1060 transaction. In this regard, the value of insurance contracts is a Class VI asset of the seller, and consideration allocated to such contracts is treated as a deemed ceding commission paid from the buyer to the seller.[12] Under the section 338 regulations, the fair market value of insurance contracts is "the amount of the ceding commission a willing reinsurer would pay a willing ceding company in an arm's length transaction for the reinsurance of the contracts if the gross reinsurance premium for the contracts were equal to old target's tax reserves for the contracts."[13]

There also are significant consequences to both the seller and buyer under sections 848 and 197 regarding deductions and capitalization of certain amounts. In this regard, life insurance companies must capitalize and amortize certain amounts of "specified policy acquisition expenses," or so-called deferred acquisition costs ("DAC") under section 848(c). DAC amounts are "intended as a proxy for an insurance company's actual cost of acquiring insurance contracts"[14] by serving as a "measure of the expenses incurred by an insurance company in connection with specified insurance contracts which should be capitalized."[15] Section 848 requires capitalization and amortization of such expenses because the expenses are allocable to the full lives of the acquired insurance contracts, but relies on a proxy system because implementing a system that accurately capitalizes and amortizes actual policy acquisition costs would be difficult to administer and enforce.[16] Generally under section 848, the amount capitalized and amortized is a specified percentage of the "net premiums" attributable to different categories of insurance contracts.

Section 197 also requires capitalization of the ceding commission, to the extent it exceeds the amount subject to DAC, paid for insurance in force (a customer-based intangible) deemed paid in a deemed assumption reinsurance transaction arising in a section 338 transaction or paid in an actual assumption reinsurance transaction effected in a section 1060 transaction. The amortization regimes of section 848 and section 197 are coordinated to the extent that reinsured contracts are subject to section 848. Generally, section 197 provides a 15-year amortization regime for "section 197 intangibles."[17] If the reinsured contracts are subject to section 848, the excess of the amount of the AGUB allocated to section 197 over the amount required to be capitalized as DAC under section 848 remains capitalized under section 197.[18] The DAC amount required to be capitalized is subject to a 10-year amortization regime and the remaining portion of the amount paid is subject to the 15-year amortization regime under section 197. If the reinsured contracts are not a type of policy specified in section 848(c), then the entire amount of AGUB allocated to those contracts would be subject to capitalization under section 197.

EXAMPLE[19]

T is an insurance company that P purchased for $16. T has Class IV assets (inventory) with total fair market value of $50, individual life insurance contracts worth $17, liabilities (tax reserves) of $50, and $20 of general deductions in the year of the stock sale. P made a section 338(h)(10) election.

The section 338(h)(10) election results in a deemed sale of the assets of old T to new T. As a result of the deemed sale, there is an assumption reinsurance transaction between old T and new T.

The ADSP and AGUB is $66 (the $16 price of the stock plus the $50 of tax reserves). $50 of the ADSP and AGUB is allocated under the residual method to Class IV assets (since the Class IV assets have a total fair market value of $50), and the remaining $16 is allocated to Class VI (which includes the value of insurance contracts).

The $16 allocated to Class VI is treated as a deemed ceding commission. New T is deemed to receive a gross amount of premium equal to the amount of old T's tax reserves ($50) for the insurance contracts and is deemed to pay a $16 ceding commission for the insurance contracts. Thus, new T's net positive consideration for the insurance contracts is $34. Because the insurance contracts are life insurance contracts, new T is subject to the DAC rules under section 848.

To calculate the DAC amount, the specified 7.7 percent is multiplied by the net positive consideration (representing the net premium amount in the context of a deemed reinsurance transaction) of $34 for a DAC amount of $2.62. Because the DAC capitalization amount of $2.62 is less than the general deductions for the year of $20, $2.62 of the $16 ceding commission is amortized under section 848 (10-year period) and the remaining $13.38 of the $16 ceding commission is amortized under section 197 (15-year period).

CEDING COMMISSION

The treatment of a ceding commission, however, has been the subject of controversy. That is, the Internal Revenue Service (IRS) has previously acknowledged that the Code and regulations treat the ceding commission as immediately deductible when assets are acquired in a section 1060 transaction involving an indemnity, rather than an assumption reinsurance transaction. A recent release from the IRS indicates a different position on the part of the IRS; i.e., that the ceding commission must be capitalized and amortized in all cases.[20] It is likely that there will be further public dialogue on this issue.

CONCLUSION

There are many considerations to take into account when purchasing an insurance company. In addition to the general tax consequences that arise from the acquisition of a company, the insurance-specific provisions provide an additional layer of complexity while maintaining the flexibility for a buyer to choose whether to purchase the stock or assets of an insurance company. ◂

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

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END NOTES

1 The authors wish to thank Frederic J. (Rick) Gelfond for his insights and comments.

2 In addition, loss carryforwards and other tax attributes are not always equally available to the Target and its shareholder and can, therefore, impact the amount of tax liability generated by a stock versus asset sale.

3 All section references herein are to the Internal Revenue Code of 1986, as amended (the Code).

4 Section 338 provides for two types of elections, described in section 338(h)(10) and section 338(g). Both elections require that a corporate buyer purchases at least 80 percent of the total voting power and value of the target corporation. A section 338(h)(10) election is often more advantageous because it recharacterizes a stock purchase as an asset purchase for tax purposes, whereas a section 338(g) election gives rise to a fictional asset sale following the actual stock purchase such that any stock gain and asset gain are both recognized. However, a section 338(h)(10) election is limited to transactions where the target corporation is either a member of the same affiliated group (within the meaning of section 1504) as the seller or is an S corporation. A section 338(h)(10) election also requires a joint election to be made by the buyer and seller, whereas a section 338(g) election is made unilaterally by the buyer. Unlike other contexts where the seller has the ability to sell an entity and treat it as an asset sale outside of section 338, such as converting the target entity to a limited liability company, insurance companies are *per se* corporations that cannot be disregarded for federal tax purposes.

5 Treas. Reg. §1.338-6.

6 "Assumption reinsurance" is a type of reinsurance pursuant to which the reinsurer is substituted for the reinsured company (also referred to as the ceding insurer) and becomes directly liable for policy claims. This generally requires a notice and release from affected policyholders. In the more common indemnity reinsurance transactions, the reinsurer has an obligation to indemnify the ceding insurer, which remains liable for claims on policies it has issued, and policyholder approval is not required.

7 Treas. Reg. §1.338-11(c). For additional analysis of the regulations under §338, see J. Howard Stecker, Gregory L. Stephenson, and Frederic J. Gelfond, "ASSUMPTION: A Single Sentence Undermines Many Principles for Taxing Insurers on 'Non-reinsurance' Acquisitions," The Insurance Tax Review (Sept. 2000), 19 Ins. Tax Rev. 375 (2000); and Gregory L. Stephenson, J. Howard Stecker, and Frederic J. Gelfond, "Mapping the Code: FSA 200144028 Successfully Orders Subchapter L and Tax Provisions of General Applicability," *The Insurance Tax Review* (January 2002), 22 Ins. Tax Rev. 47. These regulations have also been the subject of two previous *Taxing Times* articles: Mark H. Kovey and Lori J. Jones, "Highlights of the Recent Guidance on Insurance Company Acquisitions," 9 *Taxing Times,* Vol. 2, Issue 2 (September 2006), and Lori Jones, "A Practical Guide for Determining Whether a Section 338(h)(10) Election Should Be Made for a Target Insurance Company," 25 *Taxing Times*, Vol. 5, Issue 1 (February 2009).

8 Generally speaking, tax reserves are actuarially determined estimates of an insurer's future obligations under the insurance policies that it has issued and/or assumed, subject to discounting and other adjustments that apply for US federal income tax purposes.

9 Treas. Reg. §1.338-6.

10 Treas. Reg. §1.1060-1(b)(9).

11 Treas. Reg. §1.338-6 and Treas. Reg. §1.1060-1(a)(1). The ADSP and AGUB include liabilities transferred, which include the old Target's closing tax reserves (which are treated as a fixed liability in computing ADSP and AGUB).

12 Treas. Reg. §1.338-11(b)(2).

13 Treas. Reg. §1.338-11(b)(2).

14 67 FR 10640, 10644 (Mar. 8, 2002); 2002-12 IRB 651, 655.

15 ILM 20022006 (Feb. 5, 2002).

16 See id.

17 Section 197 intangibles include goodwill, going concern value, and intellectual property. See section 197(d).

18 The ceding commission paid in an indemnity reinsurance transaction is not treated as basis in a section 197 intangible, whereas the ceding commission paid in an assumption reinsurance transaction, whether actual or deemed as part of a section 338 transaction, is treated as basis in a section 197 intangible. See section 197(f)(5). See also H. Conf. Rep. No. 103-213, 103d Cong., 1st Sess. (1993), 675, fn. 25.

19 See Treas. Reg. §1.338-11(c)(4), Example 1.

20 See CCA 201501011 (Sept. 4, 2014). See also Lori J. Jones, "IRS Concludes in CCA that Section 197 Applies to All Section 1060 Indemnity Reinsurance Transactions," on page 43 of this issue.