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In the Beginning… A Column Devoted to Tax Basics
The Taxation of Reinsurance Transactions

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Reinsurance involves the transfer of risk from one insurance company to another insurance company for an agreed amount of consideration. Reinsurance accounts for a significant portion of the tax complexity in the insurance industry as it allows for the transfer of a significant amount of assets and income among entities and across borders. Understanding the basics of reinsurance and its tax implications is vital to grasping the tax rules applicable to the insurance industry.

This edition of "In the Beginning" provides a high-level overview of reinsurance: its purpose and uses, its different forms, and the tax results and issues that can arise in reinsurance transactions.

REINSURANCE OVERVIEW

Reinsurance is insurance purchased by an insurance company (the "ceding company") from another insurance company (the "assuming company" or "reinsurer") to better manage risk and/or capital. Reinsurance provides protection for the insurer from losses as a result of insurable events covered under the reinsurance contract, which is often called a "treaty."

From a risk management perspective, an insurance company may attempt to spread the risk from the insurance contracts it issues and reduce exposure to a particular type of risk or risk classes. Classes of risk that direct insurers transfer include mortality, morbidity, property losses due to wind, fire or flood, medical costs due to accident, policy lapse, credit quality, reinvestment, and disintermediation. For example, a life insurance company may reinsure some of its whole life policies with guaranteed cash surrender values to mitigate the risk that its pricing actuaries have underestimated mortality risk, as well as to alleviate the potential for credit losses or lower-than-expected investment returns.

Reinsurance may also be undertaken for capital and financial planning reasons, such as to acquire new business to generate growth in a more cost efficient manner, to sell non-core or under-performing businesses, to improve capital and surplus positions, or to provide for the acceleration of income to the current period. Reinsurance also enables ceding insurers to expand their capacity to write additional new business without the need to raise additional capital. Freeing up capital through reinsurance can allow companies to pay policyholder dividends as well as shareholder dividends earlier than they otherwise could have without reinsurance. These capital considerations arise from the state insurance regulatory framework which mandates that companies meet minimum risk-based capital standards, as well as the capital needed for financial strength ratings provided by rating agencies.

TYPES OF REINSURANCE: ASSUMPTION AND INDEMNITY

There are two general categories of reinsurance transactions: assumption reinsurance and indemnity reinsurance. Assumption reinsurance is permanent; indemnity reinsurance is ongoing and can be more flexible. The steps involved, and the purpose and tax results of these types of transactions differ in a number of significant ways.

Assumption reinsurance is the process of legally replacing one insurer with another through a novation[1] of the original insurance contract, thereby extinguishing the ceding insurer's liability to the policyholder. Assumption reinsurance is a significant one-time transaction which generally requires consent of policyholders and generally involves regulatory approval. Assumption reinsurance offers a means to transfer a block of business to another insurer; this may be advantageous when the company is no longer writing a particular class of business and no longer wants to devote capital to back the existing business or other resources to manage it. In addition, assumption reinsurance removes any credit risk to the ceding company related to the reinsurer's ability to satisfy its obligations, and eliminates the administrative burden on the ceding insurer of continuing to administer the policies. However, an assumption reinsurance transaction can be a time-consuming process in part because of the required regulatory and individual policyholder approvals. If any of the ceding company's policyholders object to the reinsurance company becoming fully responsible for the obligations under their policies, that remaining business would need to be managed, potentially through reinsurance on a coinsurance basis with a separate arrangement for administrative purposes.

Indemnity reinsurance, in contrast, is a contractual agreement between the ceding and assuming company which involves no requirements for notification and consent from existing policyholders. Indemnity reinsurance is an ongoing arrangement in which the reinsurer shares in the fortunes of the direct writer, and in doing so reduces the impact of individual risks for the direct insurer. After the transaction is entered into, the direct insurer, or ceding company, is still primarily liable to policyholders; policyholders generally are not notified of indemnity reinsurance transactions. Due to its relative simplicity, indemnity reinsurance is much more common than assumption reinsurance, and it has taken on many transactional forms. These different forms of indemnity reinsurance, discussed below, have evolved as a direct result of the continuing relationship between the ceding and assuming company, which allows for the sharing of risk on an individual policy or block of business basis. The Modified Coinsurance and Coinsurance with Funds Withheld forms of agreement (described below) mitigate concerns about reinsurer credit risk—reserve credit is available when the funds to back the reserves are retained by the direct writer, even if the reinsurer's financial strength deteriorates.

Indemnity reinsurance can be either automatic, *i.e.*, treaty reinsurance, or facultative. The key distinction is that automatic reinsurance is a broad agreement covering some portion of risk. Once the business is reinsured both parties must abide by the terms of the agreement. Facultative reinsurance, by contrast, requires the underwriting approval of the assuming company for each risk before reinsurance coverage is made available, on a policy by policy basis. The assuming company can accept or reject the risk for each policy offered.

The two major types of risk sharing in indemnity reinsurance are proportional and non-proportional reinsurance. Proportional reinsurance is the transfer of a certain percentage of risk on each individual policy. For example for each insurable event, the reinsurer will be liable for a certain percentage of the loss—or all of it. Non-proportional reinsurance is used to limit the total risk to the ceding company by the assuming company stepping in to pay the ceding company once losses exceed a certain threshold; this type of reinsurance coverage may also be called "excess loss" cover. Non-proportional reinsurance is more commonly used by non-life insurers rather than life insurers as it serves to limit the impact of catastrophic events. Stop-loss coverage is a form of non-proportional reinsurance that is written on an aggregate basis for all policies reinsured, while excess of loss cover is determined at the policy level and would only be paid when the direct insurer's loss on an individual policy exceeds the amount specified in the reinsurance agreement.

Proportional reinsurance is more common than non-proportional in the life insurance industry.

Reinsurance agreements may take one of several forms:

- Coinsurance—"plain vanilla" proportional indemnity reinsurance.[2] In a pure coinsurance agreement, the reinsurer receives a specified portion of direct premiums and accepts the obligation to pay that same percentage of policy benefits.

- Modified Coinsurance (Modco)—Assets and reserves for the reinsured business remain with the ceding insurance company. Generally, with modified coinsurance agreements the reinsurer receives a "Modco Adjustment," typically determined as an investment income credit based on the assets that remain with the direct writer, reduced by the increase in its share of reserves.
- Coinsurance with Funds Withheld (CFW)[3]—Insurance reserves transfer to the assuming company but the underlying assets remain with the ceding company. The ceding company sets up a funds withheld payable and the assuming company establishes an offsetting funds withheld receivable.
- Yearly Renewable Term (YRT)—The ceding company cedes mortality or morbidity risk generally with an increasing premium to reflect the yearly increase in risk. YRT may be used for large face amount policies that exceed a ceding company's retention limit.

Under all of these types of arrangements, the reinsurer receives its defined share of premiums and settles its share of policy benefit or claims payments, and change in reserves at regular intervals, typically via a monthly or quarterly "settlement."

CHARACTERIZATION OF REINSURANCE

For tax purposes, an acquisition transaction may be classified as assumption reinsurance in situations whereby the legal form of the transaction is a purchase of stock. Instead of obtaining policyholder approval for hundreds or thousands of policies, a corporation looking to exit a line of business may sell the stock of an insurance subsidiary that issues certain types of policies. For Federal income tax purposes, however, a section 338(h)(10)[4] election may be made which treats the stock purchase as an asset acquisition and an assumption reinsurance transaction.[5] This is the more common application of assumption reinsurance as a stock purchase with a section 338(h)(10) election does not require policyholder consent.

ACCOUNTING FOR REINSURANCE

Generally Accepted Accounting Principles (GAAP) and Statutory Accounting Principles (STAT) define reinsurance as a transaction whereby risk is transferred. This topic is covered fairly extensively in other articles, specifically with respect to captive insurance companies.[6] In short, care must be taken in structuring a transaction to assure that it transfers sufficient risk from the ceding to the assuming company; otherwise, the transaction may not be treated as reinsurance. In these situations deposit accounting must be used, which does not allow for income or loss to be recognized on the transaction.[7] The income tax rules incorporate a similar concept to GAAP and STAT risk transfer and generally employ the same deposit accounting result in the absence of risk transfer.[8] Deposit accounting negates the taxable income impact of the reinsurance transaction.

> Care must be taken in structuring a transaction to assure that it transfers sufficient risk ... otherwise, the transaction may not be treated as reinsurance.

If sufficient risk transfer is achieved, reinsurance results in a decrease to the ceding company's reserves and assets corresponding to the amount of risk assumed by the reinsurer and the fair market value (FMV) of the assets transferred. The amount of reserves transferred at inception of the reinsurance are generally classified as premiums paid by the ceding company and premiums received by the assuming company. The ceding company's decrease in reserves constitutes income, and the reinsurer's increase in reserves is deductible as an expense.

The value of the assets transferred at inception of the reinsurance may not equal the reserves transferred, and in general the difference is a "ceding commission." Depending on the value of the policies reinsured, the ceding commission may be paid by either the assuming company or the ceding company. A ceding commission paid by the ceding company is classified as a negative ceding commission and generally occurs when an unprofitable business is reinsured. The ceding commission is reported as a separate line item from the premium income/expense. Additionally, the ceding insurer recognizes gain or loss based on the difference between the GAAP and STAT basis in the assets transferred and FMV of those assets.

The tax treatment of coinsurance is generally consistent with the accounting treatment, with some modifications. In general, a ceding company recognizes as ordinary income the decrease in tax reserves transferred and the ceding commission received from the reinsurer. The ceding company may also recognize as ordinary or capital gain or loss, depending on the category of assets, the difference between the FMV and tax basis of the assets transferred. This transfer is treated as a sale of the assets transferred subject to general income tax rules.[9] The ceding company recognizes an ordinary deduction for the assets transferred as a premium payment, as well as any negative ceding commissions. The assuming reinsurer records premium income and obtains assets with tax basis equal to FMV.

The amount and deductibility of a reinsurance ceding commission for tax purposes can be a complex topic which depends on the classification of the transaction as indemnity or assumption reinsurance.[10] For life insurers in an assumption reinsurance transaction, the ceding commission is classified as the difference between the FMV of the assets transferred and the tax basis of the reserves on the business assumed.[11] For indemnity reinsurance and nonlife reinsurance, the ceding commission is the net amount as agreed in the reinsurance contract, which is "grossed-up" if netted against the premiums paid.[12]

Ceding commissions paid are generally capitalized in life assumption reinsurance transactions, which include section 338(h)(10) elections as discussed above. The ceding commission that is capitalized is the amount in excess of deferred acquisition costs (DAC) capitalized under section 848.[13] Ceding commissions in indemnity reinsurance agreements, on the other hand, are generally deductible unless they fall under a separate tax rule. Items that may override the deductibility of ceding commissions include: the transaction qualifies under Subchapter C as a tax free reorganization or capital contribution; or the transaction qualifies as an applicable asset acquisition (sale of a business) under section 1060, which could cause the ceding commission to be considered an intangible asset to be capitalized and amortized over 15 years.

POSSIBLE TAX COMPLEXITIES

Due to the introductory nature of this article, certain reinsurance-related issues are identified and briefly discussed below. Fuller discussion of these topics is left for another article or articles.

DEFERRED ACQUISITION COSTS (DAC)

Section 848 requires a "proxy" capitalization of policy acquisition costs based on a percentage of net premiums on "specified insurance contracts."[14] Specified contracts are separated into annuity, group life, and "other" and are capitalized at 1.75 percent, 2.05 percent, and 7.7 percent, respectively. These capitalized costs are amortized over either 60 or 120 months.[15] Premiums written must include premiums assumed and ceded under reinsurance agreements. Thus, the ceding company reduces the amount of DAC capitalized by its premiums ceded and the assuming company increases its DAC capitalized by the premiums assumed. The Code and regulations include specific rules to ensure the net amount capitalized between the ceding and assuming parties in a reinsurance transaction is zero so no DAC is "eliminated" through reinsurance.[16] An election under Reg. section 1.848-2(g)(8), which states that companies will compute DAC without regard to the general deduction limitation, is often included in life reinsurance treaties. The purpose of the election is to ensure the zero net impact intended by Congress.

An additional complexity exists with respect to reinsurance whereby an insurance company that cedes significant assets in a certain taxable year could record a net negative consideration for the year. For instance a situation could occur whereby the negative consideration could not be used to offset any prior year positive DAC, and that negative DAC could not be deducted but rather would need to be carried forward to offset future positive capitalization.[17]

No reduction of DAC for premiums written is allowed for reinsurance ceded to foreign insurance companies.[18] The premise of this rule is that the foreign insurance company is not subject to DAC capitalization and thus the reduction in DAC for the ceding company would not be offset by an increase in DAC at the assuming company.[19]

SECTION 845

The IRS has the authority under section 845(a) and (b) to disallow a deduction for premiums ceded if it determines a related party transaction has a tax avoidance or evasion effect, or if any reinsurance transaction, not limited to related party transactions, has a "significant tax avoidance effect," respectively. The IRS has challenged reinsurance transactions under this provision in the past with little success.[20] Companies may seek to obtain transfer pricing reports to support the arms-length pricing of the related party reinsurance transactions.

REINSURANCE BETWEEN U.S. AND FOREIGN COMPANIES

Some items of complexity in the cross-border reinsurance context include:

- Related Person Insurance Income (RPII)—Reinsurance from a U.S. insurer to a foreign affiliate could result in RPII. RPII is considered Subpart F income under section 953(c)(2). In addition, the threshold for qualification as a CFC is modified to U.S. persons owning any stock, without regard to 10 percent shareholders and voting shares requirement, and substituting 25 percent or more U.S. shareholders instead of more than 50 percent for insurance companies with RPII.[21]

- Excise Tax—Section 4371 establishes a 1 percent excise tax on premiums paid to a foreign insurance company on reinsurance of U.S. risk. Some uncertainty exists with respect to different reinsurance transactions and the definition of "premiums paid." For example, Modco and CFW do not involve a transfer of assets and thus may be interpreted as not having premiums paid for excise tax purposes upon commencement of the reinsurance treaty.[22]

- Section 953(d) entities—Foreign insurance company subsidiaries of U.S. parented groups may make an election under section 953(d)(1) to treat the foreign affiliate as a U.S. company for federal income tax purposes. This election is made to avoid the income of the foreign insurance company from being subject to both Subpart F taxation and the section 4371 excise tax. Section 953(d) companies oftentimes incur losses in earlier years, which are subject to the dual consolidated loss limitation on the ability of the consolidated group to use these losses.[23]

- U.S. trade or business—Inbound U.S. insurance companies (*i.e.*, U.S. insurance companies owned by foreign parents) may reinsure policies written on U.S. risk to foreign affiliates without being subject to Subpart F income (although these premiums are subject to the excise tax). Companies should take care to ensure they do not cause the foreign affiliate to qualify a U.S. trade or business under the Code or a permanent establishment (PE) under a tax treaty with the U.S. The analysis of whether a company has a U.S. trade or business or a PE is based on the company's specific facts and circumstances, including, as an example, a U.S. ceding company acting on behalf of the foreign affiliate as an agent with the sole purpose of reinsuring business to the affiliate.

REINSURANCE INVOLVING THE TRANSFER OF STOCK AS CONSIDERATION

In some reinsurance transactions, the ceding company receives stock in exchange for the assets and reserves that are transferred to the reinsurer. Some uncertainty exists whether the transaction would be governed by Subchapter L (insurance rules) or Subchapter C (general corporate reorganization rules). The IRS has ruled in several instances that if a transaction qualifies for one of the tax-free transfers under Subchapter C, then Subchapter C rules control and the transaction qualifies for tax-free treatment.[24] To the extent the transaction does not qualify for tax-free treatment, the value of the stock transferred must be taken into account in the amount of consideration received by the ceding company.

SECTION 1060 ASSET SALES

Ceding companies often reinsure entire blocks of business. In these situations, an analysis as to whether a section 1060 "applicable asset acquisition" has occurred is required. A section 1060 transaction generally requires the capitalization of any intangibles purchased in the transaction. Ceding commissions under assumption reinsurance are generally treated as intangible assets under section 197(f)(5) and so must be capitalized and amortized over 15 years.

The IRS has asserted that an indemnity reinsurance transaction that qualifies under section 1060 would require the capitalization of ceding commissions.[25] Commentators have disagreed with the IRS due to the plain language of section 848(g) which states that "[n]othing in any provision of law (other than this section or section 197) shall require the capitalization of any ceding commission incurred on or after September 30, 1990, under any contract which reinsures a specified insurance contracts." Section 197(f)(5) specifically applies only to assumption reinsurance[26] and section 848 is silent on whether capitalization of ceding commissions is required for indemnity reinsurance transactions.

OPERATION OF THE CONSOLIDATED RETURN RULES

Many reinsurance transactions occur between members of a group which files a consolidated tax return. The matching and acceleration rules in Reg. section 1.1502-13 govern the treatment of these reinsurance transactions.[27] To the extent the income and expense items for the transaction offset each other, the reinsurance transaction is respected and the income and expense items are recognized at each separate entity. For example: premium expense and premium income, change in reserves,[28] and DAC are all items that would generally be reflected in taxable income at the time of the transaction.

The ceding commission in an indemnity reinsurance transaction is recognized immediately. The ceding commission in an assumption reinsurance transaction is generally deferred due to the fact that the assuming company must capitalize it. As the assuming company amortizes the ceding commission over 15 years, the ceding company recognizes the income from the ceding commission.

Another intercompany item of income or loss that is generally deferred is the ceding company's built-in gain or loss on the assets transferred. This deferred income or expense would be recognized at the time the entities or the assets transferred are no longer part of the same consolidated return.

ACCOUNTING FOR INCOME TAXES: ASC 740 & SSAP 101 IMPLICATIONS

Complexities abound with respect to accounting for income taxes from reinsurance transactions. A significant sale of assets requires an accurate calculation of current tax expense and recognition of existing deferred tax assets and liabilities. Also, the recording of separate entity impacts of transactions between members of a consolidated return can be complicated and burdensome to track. Finally, companies may use reinsurance transactions as a tax planning tool for purposes of their valuation allowance and SSAP 101 admissibility calculations. The ability of reinsurance transactions to generate significant one-time income lends itself to tax planning considerations. Care must be given to whether these reinsurance transactions are prudent and feasible.

IN CONCLUSION

This article has sought to provide an overview of the purpose, types, and treatment of reinsurance transactions so that readers will be able to identify tax issues and areas of further research when encountering reinsurance transactions. Reinsurance is a topic to which tax professionals can add significant value by mitigating risk and providing guidance as to tax-efficient transaction structures.

Disclaimer: The article does not constitute tax, legal, or other advice from Deloitte Tax LLP, which assumes no responsibility with respect to assessing or advising the reader as to tax, legal, or other consequences arising from the reader's particular situation. ■

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ENDNOTES

1 Novation is an agreement to replace one party to an insurance or reinsurance agreement (ceding company) with another insurance company (reinsurer) from the inception of the coverage period.

2 Unless otherwise noted, the accounting and tax treatment of indemnity reinsurance described below apply to coinsurance.

3 Modco & CFW are often used to allow a ceding company to take a reserve credit for reinsurance with a foreign or unauthorized reinsurer. Insurance regulators generally do not allow a reserve credit if assets are transferred to foreign or unauthorized reinsurers under the premise that satisfaction of the reinsurer's contractual obligations would not be sufficiently assured. When the ceding insurer retains the assets that support the ceded business, the regulators can be assured the assets will be available to satisfy policyholder obligations. Historically, insurance companies were required by regulators to transfer the assets backing the reinsured reserves into a trust to satisfy insurance regulators. However, more recently Modco and CFW have been used without the need for a trust.

4 Unless otherwise indicated, all section references are to the Internal Revenue Code of 1986, as amended, and the regulations thereunder.

5 Reg. section 1.338-11(c).

6 Captives generally insure or reinsure the risk of the captive's owner(s) and affiliates. They provide a method for self-insuring or for pooling risks with other companies without the use of third party insurers. The popularity of captives has increased in the past two decades and they are now used for many types of risks. Life insurers also use captive reinsurance companies for certain types of products for surplus relief. *See* further discussion on captive developments in Logan R. Gremillion, Beyond Safe Harbors: Recent Developments in Insurance & Risk Distribution, 56 Tax Management Memorandum 253 (July 13, 2015).

7 *See* ASC 340-30 and SSAP 61 Paragraph 17.

8 CCA 201503011 (January 1, 2015) which states, "In limited circumstances, where an arrangement purporting to be insurance is not insurance for federal income tax purposes, the arrangement may still support a deduction under section 162 as an ordinary and necessary business expense for the parent's payment of the premium and inclusion of the amount of the premium in the captive's income under section 61. Any losses paid by the captive, in that case, would be deductible to the captive when paid, and not before because, as stated in Rev. Rul. 2007-47, 2007-30 I.R.B. 127, '[i]f an arrangement is not an insurance contact, no reserves are permitted for unearned premiums or for discounted unpaid losses with respect to the arrangement.'"

9 *E.g.* sections 1001 (sale of capital assets), 1045 (ordinary income recapture), 1276 (accrued market discount recapture).

10 Reg. section 1.809-5(a)(7)(ii) defines assumption reinsurance for tax purposes.

11 Reg. section 1.817-4(d) prescribes the income tax treatment of assumption reinsurance.

12 *See* Rev. Rul. 70-552, 1970-2 CB 141, which states "Further, the accrual of the foregoing rights and obligations and their treatment for Federal income tax purposes are not affected by the fact that the primary insurer 'netted out' the ceding commission against the pro rata gross premium so that only a net amount was paid to the taxpayer."

13 Section 197(f)(5).

14 For a more detailed discussion of DAC *see* Stephen Baker, "In the beginning … A Column Devoted To Tax Basics, Tax DAC," *Taxing Times*, Vol. 13, Issue 1 at 8 (February 2017).

15 Premiums on reinsurance contracts are only amortized over 120 months under section 848(b)(4).

16 Section 848(d)(4)(A).

17 Section 848(f) and Reg. section 1.848-2(i)(2), (3).

18 Reg. section 1.848-2(h)(1).

19 An election is available under Reg. section 1.848-2(h)(3) to compute DAC for foreign reinsurance separately. The mechanics of the election would allow any net negative consideration on foreign reinsurance to offset future net positive consideration on foreign reinsurance.

20 *See* Trans City Life Ins. Co. v. Commissioner, 106 T.C. 274, 302 (1996) (holding that the IRS abused its discretion when it determined that a reinsurance agreement among two unrelated insurers had a significant tax avoidance effect), compare FAA 20092101F (May 22, 2009) (concluding that the proposed tax treatment of a reinsurance transaction between two related parties should be disallowed under section 845(b) because it had a significant tax avoidance effect).

21 Section 953(c)(1).

22 For further commentary on this topic *see* Brion D. Graber, Determining "Premiums Paid" For Purposes Of Applying The Excise Tax To Funds Withheld Reinsurance" 78 *Reinsurance News*, 14 (March 2014).

23 Section 953(d)(3).

24 *See* Rev. Rul. 94-45, 1994-2 CB 39 (assumption reinsurance), PLR 201511015 (March 13, 2015) (concluding that the indemnity reinsurance transaction did not qualify under section 351 for tax free treatment and thus Subchapter L was applicable) ; PLR 201506008 (February 6, 2015) (concluding that an indemnity reinsurance transaction in exchange for stock can qualify under section 351 as a tax free contribution due to the permanence of the reinsurance agreement).

25 CCA 201501011 (January 2, 2015) clarified by CCA 201642032 (October 14, 2016) in which the IRS recharacterized the transaction as assumption reinsurance for tax purposes to reach the same conclusion. "We have reconsidered our analysis and now conclude that, in a section 1060 acquisition, the section 338 regulations apply with respect to the basis allocation rules only and do not treat the acquisition of insurance contracts as an assumption reinsurance transaction."

26 For a more in depth analysis of the treatment of ceding commissions in the context of whether they are deductible or capitalized *see* William Pauls, "IRS Assumes Away Inconvenient Law in Reinsurance CCA," 147 Tax Notes 277 (April 20, 2015).

27 Reg. section 1.1502-13(e)(2)(ii)(B)(1).

28 An exception exists for reserves to be calculated on a separate entity basis whereby the assuming company may calculate reserves differently than the ceding company and that difference in reserves is recognized currently.