



Article from
Taxing Times
February 2019
Vol. 15 Issue 1

Unique Tax Issues in LTC Transactions

By Peter J. Sproul, with contributions from Peggy Hauser and Mark S. Smith

Tax issues with reinsurance transactions can be complicated. There are some unique tax issues associated with long-term care (LTC) transactions that make after-tax modeling crucial to economic analysis. We will explore these issues in this article.

Several insurers with closed blocks of LTC have considered exiting the business through reinsurance or stock sale transactions. In theory, it should be possible to structure a deal, whether reinsurance or stock sale, that economically works for both buyer and seller in a particular transaction on an after-tax basis.

A key challenge in structuring many LTC transactions is the tax friction cost caused by increases in nondeductible additional reserves, increases that have required additional capital to keep LTC insurers solvent. Two types of additional reserves include:

1. **Premium deficiency reserves.** Whenever a significant doubt exists as to reserve adequacy, life insurers are required to complete a gross premium valuation, which tests whether future gross premiums and reserves are sufficient to cover expected future claims and expenses. In the event inadequacy is found to exist, immediate loss recognition must be made and the statutory reserves restored to adequacy. Such increased statutory reserves are then considered the minimum reserves for that insurer. This deficiency can occur for a number of reasons, including underpricing, inadequate morbidity assumptions and low investment yields. Positive results from another line of business cannot be used to offset deficits in LTC.
2. **Asset adequacy testing (AAT) reserves.** AAT reserves typically result from some form of cash flow testing, which is a robust testing process for the purpose of assessing whether cash inflows from assets are sufficient to cover the cash outflows from the related policy liabilities. A company can offset LTC deficiencies with other product's sufficiencies only if they use a cash flow testing method to do both their AAT for LTC and all other significant lines of non-LTC business.

Whether due to cash flow testing or gross premium valuations, these additional reserves are nondeductible reserves under Section 807(d)(3)(C).¹ As a result, these additional reserves merely serve to increase deferred tax assets (DTAs) that may not be admissible under statutory accounting principles. Therefore, the insurer may not receive a current or deferred tax benefit to offset the surplus impact of an increase in additional reserves (although conversely there is no tax expense if and when the reserves are released, as no tax deduction was taken).

This article describes the tax friction cost caused by nondeductible reserves in reinsurance and stock transactions. Tax friction costs also arise due to negative ceding commissions and tax-deferred acquisition costs (DAC tax) under Section 848. These same tax friction costs may arise for transactions involving other types of life and health insurance business. For LTC, this tax friction cost is just exacerbated by the higher level of additional reserves often held and the low or negative appraisal values often assigned to blocks of business.

WHAT TAX ISSUES ARISE WITH REINSURANCE OF LTC BUSINESS?

In a reinsurance transaction, assets backing statutory reserves (including nondeductible reserves) are transferred with the business (*i.e.*, the reinsurance premium is set equal to the statutory reserves and associated liabilities). In addition, a ceding commission (or negative ceding commission) is paid. From a statutory perspective, a gain or loss is recognized for the ceding commissions paid and any realized gains or losses on invested asset transfers (*e.g.*, investment securities). For the purposes of this article, we'll assume that there are no realized gains and losses on asset transfers. However, in practice, the tax impacts of realized gains or losses and statutory interest maintenance reserves being assumed as part of a transaction need consideration. We'll also assume the reinsurance is "mere" coinsurance and not part of a capital transaction (*e.g.*, a sale of a business to which goodwill applies).

For coinsurance transactions, the taxable income result is generally symmetrical for the ordinary income or loss recognized by both sides to the transaction.² The reinsurance premium paid is deductible for the ceding company and taxable to the assuming company. The tax basis of the reserves transferred creates additional taxable income for the ceding company and deduction for the assuming company. For ceding commissions paid, there can be complexity depending on the type of business and how the DAC tax rules apply. As a general matter outside of capital transactions (*e.g.*, reinsurance as part of a larger acquisition of a business to which goodwill applies under Section 1060), the goal again is symmetry as to the deduction and income recognized by both parties to the reinsurance transaction.

Because some statutory reserves are not deductible for tax purposes, the assuming company generally will recognize immediate taxable income for the difference between the statutory and tax basis reserves, as there is no offsetting deduction to its gross income from the related reinsurance premium received. The ceding company generally will have the opposite result, because there will be no taxable income from its decrease in nondeductible reserves but a deduction for the related reinsurance premium paid. This is illustrated in the following coinsurance Example 1.

This upfront tax cost for the assuming company happens on any reinsurance where the excess of the statutory over the tax reserves, as well as any DAC on the net consideration received, exceeds any positive ceding commission paid. As mentioned previously, this upfront tax friction cost of \$84 for the assuming company can be significantly exacerbated for blocks of LTC business because nondeductible reserves often make up a substantial portion of the statutory reserves, and the ceding commission may be negative instead of positive (even with high statutory reserves).

To make matters worse, the amount of general expenses that is capitalized as DAC is 9.2 percent of net premiums, because LTC

falls into the “other category” under Section 848. The combination of the statutory-tax reserve differences and DAC tax, as well as negative ceding commissions, could make many transactions unattractive to the assuming company where the tax friction cost is significant and after-tax parity cannot be achieved through a pricing adjustment, or by changing the form of the reinsurance (discussed further below). Future deductions for actual losses and amortization of DAC tax over 15 years make this a timing matter; however, the present-value cost could still be significant to the assuming company.

As a result, an assuming company may seek a pricing adjustment (often referred to as a “tax gross-up”) to compensate for its tax friction cost in assuming the business. To provide this compensation in a way that is after-tax neutral, a ceding company would need to be in a position to benefit from its deductions generated by the reinsurance transaction, including any additional payments to the assuming company for its tax friction cost.

The following tax gross-up discussion and examples are simplified and ignore considerations such as the present value of future deductions the assuming company will receive for DAC tax amortization and nondeductible reserves as they reverse over time. Any tax gross-up payment also will create additional net

Example 1
Coinsurance Approach

Assumptions

Statutory reserves = 1,000
Tax reserves = 800
Negative ceding commission = 100
DAC tax rate = 9.2%
Net consideration = 1,100

Income/(Deduction)	Ceding Company	Assuming Company	
Reinsurance premium paid	(1,000)	1,000	
Decrease/(increase) in tax reserves	800	(800)	
Negative ceding commission paid	(100)	100	
DAC (1,100 @ 9.2%)	(101)	101	
Taxable (loss)/income	(401)	401	
Tax (benefit)/expense @ 21%	(84)	84	

Reconciliation of statutory to taxable income:

Statutory (loss)/gain before taxes	(100)	100	Ceding commission paid
Nondeductible reserves	(200)	200	Difference between the statutory and tax reserves transferred
DAC	(101)	101	
Taxable (loss)/income	(401)	401	

consideration subject to DAC tax that complicates any attempt to achieve after-tax parity. The relative tax positions of both parties will factor into any tax gross-up payment. For example, an assuming company with net operating losses (NOLs) may be able to use those losses to offset its immediate taxable income and any tax expense resulting from the reinsurance transaction.

This tax gross-up concept is illustrated in Example 2, which uses the same facts from Example 1 and includes the additional tax gross-up payment.

If the ceding company cannot immediately benefit from its taxable loss, the tax gross-up payment may not create after-tax parity. For example, if the taxable loss generates additional NOLs to carry over to future years, the ceding company has no reduction in its current tax expense and will only receive a deferred tax benefit in statutory surplus to the extent its deferred tax asset for the NOLs is admissible. In the example, the after-tax loss and reduction in surplus therefore could be much higher (worst case, \$207 with no current or deferred tax benefit).

To ease the tax friction cost for the assuming company, the type of reinsurance also could be changed to funds withheld (FWH) or modified coinsurance (Modco), where the upfront DAC tax effect is lessened (FWH and Modco) or the statutory and tax basis reserves do not actually transfer (Modco only). For example, the upfront DAC tax effect is lessened as the net reinsurance consideration subject to capitalization under Section 848 is reduced by the increase in the FWH or Modco “loan” for the assets still held by the ceding company.³ In Modco, there also is no upfront tax deduction (ceding company) or income (assuming

company) for the lower tax basis in the statutory reserves as they are not being transferred. Instead, the ceding company retains the Modco reserves and any related statutory-tax basis difference.

Example 3 illustrates a Modco approach. This example uses the same facts as in the previous examples, except that the statutory and tax basis reserves do not transfer to the assuming company and all that is paid upfront is the negative ceding commission of \$100.

As compared to Example 2, the tax gross-up is lower to achieve the same after-tax result. The statutory and tax reserves staying with the ceding company results in no immediate taxable income for the assuming company and a lower DAC tax amount with less consideration paid.

In summary, unless the right tax profiles exist to enable the ceding company to realize the tax benefits of deductions created by the transaction (or to enable the assuming company to offset its upfront taxable income created by the transactions), the tax friction cost could become too unpalatable to either party to the proposed reinsurance transaction.

HOW ARE THE ISSUES DIFFERENT IN A STOCK SALE TRANSACTION?

What if an insurance company with LTC, or other lines or business with nondeductible reserves and low or negative appraisal values, is being purchased in a stock transaction?

The U.S. federal tax rules applicable to stock sale transactions are different than for reinsurance transactions and can be complex, especially when selling a company that has experienced losses

Example 2
Coinsurance With Tax Gross-up Payment

Income/(Deduction)	Ceding Company	Assuming Company
Immediate taxable (loss)/income per Example 1	(401)	401
Tax gross-up payment [401 × (tax rate)/(1-tax rate)]	(107)	107
Revised taxable (loss)/income	(508)	508
Revised tax (benefit)/expense @ 21%	(107)	107

After-tax gain/(loss):

Negative ceding commission paid	(100)	100
Tax gross-up payment (i.e., tax pricing adjustment)	(107)	107
Total (loss)/gain before taxes	(207)	207
Less: tax benefit/(expense) per above	107	(107)
After-tax (loss)/gain	(100)	100

Example 3
Modco Approach

Assumptions

Modco reserves = 1,000 (equals the statutory reserves)
Net consideration = 100 (ignores tax gross-up payment)

Income/(Deduction)	Ceding Company	Assuming Company	
Reinsurance premium paid	(1,000)	1,000	
Modco reserves adjustment	1,000	(1,000)	
Negative ceding commission paid	(100)	100	
DAC (100 @ 9.2%)	(9)	9	
Taxable income/(loss) before tax gross-up	(109)	109	
Tax gross-up payment [109 × (tax rate)/(1-tax rate)]	(29)	29	
Taxable (loss)/income	(138)	138	
Tax (benefit)/expense @ 21%	(29)	29	

Reconciliation of statutory to taxable income:

Statutory (loss)/gain before taxes (Ceding Commission plus Tax Gross-up)	(129)	129	Ceding commission plus tax gross-up
Nondeductible reserves	–	–	Reserves not transferred
DAC	(9)	9	
Taxable (loss)/income	(138)	138	
After-tax gain/(loss)	(100)	100	\$129 statutory loss before tax less \$29 tax benefit

(a “loss company”). However, they may provide more flexibility compared to a reinsurance transaction. A deep technical analysis on the stock sale tax rules is beyond the scope of this article. The following discussion will focus more on the key concepts and how the tax result compares with a reinsurance transaction.

A sale of stock ordinarily generates a capital gain or loss for the seller and carryover tax basis in the assets of the target company. For loss companies with unused tax attributes (e.g., NOLs), there are rules to prevent companies being sold for their tax attributes. The most well-known is the annual limitation placed on the use of NOLs at the time of an ownership change under Section 382. The annual limitation amount is generally the value of the company at the time of the ownership change multiplied by the long-term tax-exempt interest rate. For a loss company that has no or minimal value, any tax attributes that remain with the company therefore become worthless to a buyer. This limitation can also apply to certain unrealized or “built-in” tax losses at the time of the ownership change.

As a general statement, a better outcome is achieved if the seller can use or retain its tax attributes that would otherwise be

worthless in the hands of a buyer. This may not always be possible. There is a joint tax election available under Section 338(h) (10) for the seller and buyer to treat a qualifying stock sale as an asset sale for tax purposes. This may allow the seller to retain and use tax attributes of the target company (not transferred in an asset sale), as well as generate ordinary losses in place of a capital loss on the stock. This gets complex and would need to be modelled for both sides to the transaction. Generally, the deemed asset sale treatment for a target company with no or minimal value will generate a tax friction cost for a buyer. At a high level, this tax friction cost results from the buyer inheriting a reduced or “stepped-down” tax basis in the target company’s assets and potentially recognizing immediate taxable income for reestablishing DAC tax on the net consideration deemed to be transferred in the hypothetical assumption of the insurance liabilities.

Before we go any deeper into the woods, let’s go back to the same fact pattern as used in Example 1. Let’s assume the negatively valued business with nondeductible reserves is all that is owned by the target company. The target company has no tax attributes or built-in losses subject to limitation under Section 382.

In a stock sale, the seller’s capital loss will reflect its difference between the sale proceeds (assumed none or minimal) and its adjusted tax basis in the stock. The seller’s stock basis will reflect what it paid for the stock, plus capital contributions, less distributions, and any adjustments for taxable earnings or losses already reflected in the seller’s consolidated tax return. Where the seller has had to contribute capital to fund additional nondeductible reserves, this will have increased its tax basis in the stock while no deduction has yet to be recognized by the target company. Upon the sale of the stock, the seller will therefore recognize a capital loss for the capital contributed to fund the nondeductible reserves, as well amounts contributed for the negative valuation.

This is illustrated in Example 4, using the same facts in Example 1 (Note: the \$100 negative ceding commission is now additional capital contributed prior to sale).

Example 4
Stock Sale

Statutory reserves & liabilities = 1,000 (including 200 nondeductible additional reserves)	
Total assets = 1,100	
Net assets = 100	
Capital contributed = 300	
Deficit in surplus = 200	
Net capital & surplus = 100	
Stock purchase price = 0	
Seller stock sale proceeds	0
Less: adjusted stock basis (equals capital contributed)	(300)
Capital gain/(loss) on sale of target’s stock	(300)

The \$300 capital loss is effectively the capital contributed to fund the \$100 negative valuation and the \$200 of additional nondeductible reserves.

Compare this capital loss to Example 1, where the ceding company recognized a \$401 taxable loss. The loss before taxes in the stock sale is economically the same as in the reinsurance scenario of Example 1. For tax, there are two differences: (1) The reinsurance loss is ordinary, not capital; and (2) the reinsurance transaction generated an additional \$101 DAC tax deduction. Especially if the seller cannot use its capital loss,⁴ the reinsurance result looks to be the better tax outcome for the seller. However, in the stock sale, the buyer is not recognizing immediate taxable income, so its tax friction cost is lower. The comparison of the after-tax outcomes will depend on the seller being able to use its capital loss. If it can, its after-tax loss could be lower than where the buyer would not require a tax gross-up. Both scenarios need

modelling to truly compare, but the differences in the tax result and any pricing adjustment could be starkly different.

Unified Loss Rules

A final twist and complication for a stock sale is the unified loss rules. In our fact pattern, the nondeductible reserves may pose a challenge and create a tax friction cost for the buyer.

The unified losses rules (ULR) are U.S. federal tax rules intended to prevent two taxpayers from both obtaining a deduction for the same single economic loss (a duplicated loss).⁵ The ULR rules are complex and apply to selling a member of a consolidated tax return. A full discussion of these rules is beyond the scope of this article.

To determine whether there is a duplicated loss, the ULR generally compare the seller’s net tax loss on the stock (the outside loss) to the net tax loss that would be realized on the sale of target company’s net assets (the inside loss). The lesser of the outside and inside loss is viewed as the single economic loss that could be deducted twice, first on the stock sale by the seller and later by the buyer through the buyer inheriting an unrealized tax loss in the target company’s assets. This amount is the tax attribute reduction that must be applied to reduce the buyer’s inherited tax attributes and tax basis in the assets of the acquired company. The reduction amount is applied under ordering rules that first reduce tax attributes and then reduce the tax basis in company’s assets (except for cash).⁶

This is illustrated in Example 5, using the same facts as in Example 4.

Example 5
Unified Loss Rules

Tax basis in assets	1,100
Less: Tax basis in reserves & liabilities	(800)
Net “inside” tax basis	300
Value of the stock being sold	0
Aggregate inside gain/(loss) [=A]	(300)
Net capital gain/(loss) on stock sale per Example 4 [=B]	(300)
Potential duplicated tax loss (lower of A & B)	300

The duplicated loss would be applied to reduce the buyer’s tax basis in the assets of the target company from \$1,100 down to \$800. This is to prevent the buyer from benefitting in the future from a deduction of \$300 for the same economic loss recognized by the seller on the stock sale. In ULR theory, the buyer has inherited a company with \$300 of losses not yet recognized



for tax purposes. Rather than reduce this future loss, the rules instead require the recognition of additional taxable gains on the assets. While this may appear to be a wash, in reality for the insurance company, it may not wash over time to the extent the gains and losses are recognized in different taxable years. For example, some of the assets with a reduced tax basis (*e.g.*, receivables) may be settled in a relatively short time period and require the company to pay tax on gains now with future losses that cannot be carried back to recover the additional taxes paid.

Where nondeductible reserves are significant, it is not uncommon for this tax basis reduction to reduce the buyer's inherited tax basis in the invested assets of the target company. This, therefore, can impact a buyer's intention with regard to re-positioning the invested assets post-acquisition, as selling the invested assets will accelerate taxes payable on the higher tax gain.

There is some good news.

The duplicated loss provisions in Treas. Reg. § 1.1502-36(d)(6) allow the seller to elect to reduce its stock basis and resulting capital loss. This reduces the duplicated loss and allows the buyer to preserve dollar-for-dollar its net inside tax basis in the assets of the acquired company. Therefore, if the seller does not expect to use all of its capital loss, the seller and the buyer may be able to reach an agreement allowing both sides to optimize their outcomes. Also, there are tax elections under these provisions that would allow the seller to reattribute certain tax attributes to itself in lieu of capital losses on the stock sale, similarly allowing

the buyer to potentially preserve its inherited tax basis in the assets of the acquired company.

Ultimately, this flexibility that the ULR affords may present the best outcome for both parties to a sale transaction involving LTC or lines of business with a similar profile.

CONCLUSION

The income tax effects can heavily distort deal economics for LTC transactions. The after-tax economics need to be modeled and analyzed to fully assess the tax impact of different forms of a transaction that may achieve the same pre-tax result. Changes in the form of the transaction could significantly alter the tax effects, and certain tax elections may be available to achieve the best outcome for both sides. Future surprises can also be avoided (*e.g.*, reductions in surplus due to higher tax costs) and enable informed decisions before entering into transactions. ■

Peter J. Sproul is a principal in the Boston office of PricewaterhouseCoopers LLP (PwC), specializing in the taxation of insurance companies. He can be reached at peter.j.sproul@pwc.com.

Peggy Hauser, FSA, MAAA, is a managing director in PwC's actuarial services practice and may be reached at peggy.hauser@pwc.com.

Mark S. Smith is a managing director in PwC's Washington National Tax Services and may be reached at mark.s.smith@pwc.com.

ENDNOTES

- 1 References to "Section" and "\$" are to sections of the Internal Revenue Code of 1986, as amended, and all "Treas. Reg." references are to the regulations promulgated thereunder.
- 2 See Treas. Reg. § 1.817-4(d), referring to transactions not involving a capital sale or exchange. For an assumption reinsurance transaction, whether actual or deemed, the taxable income result is not symmetrical where the buyer would need to capitalize certain consideration paid and defer deductions, while the seller would immediately recognize its gain or loss.
- 3 See Treas. Reg. § 1.848-2(f)(5).
- 4 For US Federal tax purposes, a capital loss is generally harder to use because it can only offset capital gains and expires if not used after five years. Ordinary losses can offset ordinary income and capital gains and no longer expire beginning with NOLS generated in 2018 (except for nonlife insurance companies).
- 5 In particular, the duplicated loss provisions in Treas. Reg. § 1.1502-36(d) must be considered.
- 6 See Treas. Reg. § 1.1502-36(d)(4) for the tax attribute reduction rules.