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IRS Chief Counsel Advice: Section 1060 insurance acquisition—deductibility of ceding commissions

The IRS publicly released a Chief Counsel Advice (CCA) memorandum that addresses a life reinsurance business acquisition, whereby a subsidiary entered into a retrocession agreement with a seller when it acquired the seller's life reinsurance business. CCA 201642032 (released October 14, 2016, and dated June 29, 2016)

The issue was whether the excess of the ceding commission over the section 848 specified policy acquisition expense must be amortized pursuant to section 197 rather than being deducted immediately. The IRS concluded that the excess ceding commission was not currently deductible, but instead was to be treated as a section 197 intangible amortized over 15 years. The IRS reasoned that the retrocession agreement is to be treated as an assumption reinsurance agreement at the time of acquisition because the seller agreed to use all efforts to obtain novations, even though at the time of acquisition the contracts were not novated. Ultimately, the life reinsurance agreements were novated, and the seller's obligations were completely extinguished.

Read **CCA 201642032** [PDF 79 KB]

Background

Parent owns 100% of Subsidiary, a life insurance company. Pursuant to a Master Asset Purchase Agreement, the Subsidiary purchased certain assets used in Seller's life reinsurance business pursuant to a retrocession agreement with the Seller (the "Agreement"). The life reinsurance contracts were held in connection with the Seller's trade or business, and the IRS stated that transaction qualifies as an applicable asset acquisition under section 1060. Under the Agreement and the ancillary, Retrocession Agreement, the Subsidiary agreed to maintain the 100% coinsurance and to provide administrative services with respect to each of the life reinsurance contracts until their expiration or until the Subsidiary and Seller obtained an executed novation and release agreement from each company Seller reinsured ("Retrocedent") with respect to such contracts.

Under the Agreement, Subsidiary and Seller agreed to use commercially reasonable efforts to obtain executed novation and release agreements from the Retrocedents. Subsidiary and Seller further agreed that, upon receipt of an executed novation and release agreement the following would occur: (1) Subsidiary would be substituted for Seller under the life reinsurance contracts; (2) Seller would be deemed to have ceased to be a party to the life reinsurance contracts and would be forever discharged from all obligations; and (3) the Retrocedent would look solely to the Subsidiary for performance of any and all obligations and liabilities owed to the Retrocedent under the retroceded life reinsurance contracts.

The Agreement provided an 18-month window to effect the novations. In fact, the novations were completed over a two- to three-year period, which was consistent with the Sellers' 'commercially reasonable' efforts.

For statutory accounting purposes both the Subsidiary and the Seller treated the reinsurance portion of the Agreement as indemnity reinsurance. For federal income tax purposes, Subsidiary deducted the excess ceding commission in Year 1.

Statutory provisions

Section 848 provides that an insurance company must amortize its "specified policy acquisition expenses" for the tax year. In lieu of identifying the specific expenses that must be capitalized, section 848 requires a company to amortize an amount of otherwise deductible expenses equal to specified percentages of the net premiums for certain types of specified insurance contracts. Section 848(g) states that nothing in any provision of law (other than section 848 and section 197) requires the capitalization of any ceding commission incurred on or after September 30, 1990, under any contract which reinsures a specified insurance contract.

Section 197 provides for an amortization deduction with respect to any amortizable section 197 intangible. The amount of the deduction is determined by amortizing the adjusted basis of such intangible ratably over a 15-year period. Section 197 generally applies to insurance and annuity contracts acquired from another person through assumption reinsurance.

In general, reinsurance may be classified as either indemnity or assumption reinsurance. In an indemnity arrangement, the ceding company remains solely liable to the policyholders and passes a portion or all of the insured risk to the reinsurer. The ceding company retains its liability to and its contractual relationship with the insured. In contrast, assumption reinsurance is an arrangement in which the assuming company (the reinsurer) becomes solely liable to the policyholders on the contract transferred by the ceding company. Effectively, it is the sale of 100% of the transferring insurer's interest in a block of business.

CCA findings

In this situation, Subsidiary acquired the life reinsurance contracts and held them in connection with its trade or business. Under the Agreement, Subsidiary and Seller intended that Seller's obligations would be extinguished through novation and release agreements and agreed to use commercially reasonable efforts to cause Subsidiary to assume each of the life reinsurance contracts. As a result of the Agreement, Seller's obligations were in fact extinguished. The Agreement provided that Subsidiary would be responsible for the life reinsurance contracts. The Retrocedents paid their premiums directly to the Subsidiary who performed the following duties: (1) paid all claims under the life reinsurance contracts; (2) sued or defended, at its own expense, any action brought against it, or any action naming Seller as a defendant; and (3) had control and direction over litigation. These facts support the conclusion that the reinsurance portion of the Agreement was an assumption reinsurance arrangement and accordingly not an indemnity reinsurance arrangement. Therefore, for federal income tax purposes, under section 848(g), Subsidiary must amortize the excess of the ceding commission over a 15-year period.

KPMG observation

This CCA, in part, applies a "step transaction" analysis to conclude that the overall transaction is to be treated as an assumption reinsurance transaction, and that the initial indemnity reinsurance transaction is to be subsumed within the assumption reinsurance provisions. This CCA notes that previously, in CCA 201501011, the IRS concluded that because the section 1060 regulations apply the principles of the section 338 regulations to an applicable asset acquisition of an insurance company, a reinsurance contract acquired as a part of a section 1060 acquisitions was treated as an assumption reinsurance transaction. The IRS reconsidered its analysis and 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.

This is the first instance when the IRS has applied a step transaction treatment in a reinsurance transaction. The CCA ignores the fact that the reinsured contracts were not novated at the time of the section 1060 acquisition. Until the novations were obtained, the reinsurance transaction was in fact an indemnity reinsurance arrangement. Notwithstanding the agreement to use commercially reasonable efforts to obtain the novations, it was not known until a later date (here two-to-three years) whether such efforts would result in a complete novation. The IRS appears to be looking backwards at this transaction with the hindsight knowledge that the novations were actually obtained. If a similar agreement had been in place, but the efforts to obtain novations were not successful, it is unclear if the IRS would have required assumption reinsurance classification.

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