OFFICE OF
CHIEF COUNSEL

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224
September 20, 2001

Number: **200144028**
Release Date: 11/2/2001
TL-N-515-01/CC:FIP:4
UIL: 817.06-00 R84
338.60-00
338.70-00
1060.00-00
1060.01-04

INTERNAL REVENUE SERVICE
NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR

FROM: Donald J. Drees, Jr..
Senior Technician Reviewer
Branch 4
Office of Associate Chief Counsel
(Financial Institutions and Products) CC:FIP:4

SUBJECT:

This Chief Counsel Advice responds to your memorandum dated May 17, 2001. In accordance with § 6110(k)(3) of the Internal Revenue Code, this Chief Counsel Advice should not be cited as precedent.

LEGEND

Taxpayer =

XYZ business =

XYZ policies =

X Group =

Date-a =

Seller =

$a =

$b =

$c =

$d =

$e =

$f =

Taxable Year A =

ISSUE

What is the appropriate method of determining Taxpayer's basis in an indemnity reinsurance ceding commission if Taxpayer acquires the XYZ business of another insurance company and, as part of the same transaction, also reinsures a block of the selling company's existing XYZ policies in an indemnity reinsurance agreement?

CONCLUSIONS

1. The transfer of Seller's XYZ business, including the transaction in which Taxpayer reinsured a block of Seller's existing XYZ policies in the indemnity reinsurance agreement, constitutes an applicable asset acquisition under § 1060(c). Therefore, Taxpayer is required under § 1060(a) to allocate the total consideration among the group of assets transferred (including the future earnings of Seller's existing XYZ policies which were transferred to Taxpayer as a result of the indemnity reinsurance agreement) using the residual method of allocation prescribed by the regulations under § 338(b) (§§ 1.338(b)-2T and 1.338(b)-3T) and § 1060(a) (§§ 1.1060-1T(d) and (e)).

2. In applying the rules for allocating the total consideration set forth in §§ 1.1060-1T(d) and (e), Taxpayer's total consideration under § 1.1060-1T(c)(1) is the cost of all of the assets of Seller's XYZ business which were transferred in the taxable acquisition, including any assets transferred in the indemnity reinsurance agreement. Therefore, Taxpayer's total consideration includes the tax reserves on Seller's existing XYZ policies which Taxpayer assumed as a result of the indemnity reinsurance agreement. Similarly, in applying the residual method prescribed by the regulations under § 338(b) (§§ 1.338(b)-2T and 1.338(b)-3T) and 1060(a) (§§ 1.1060-1T(d) and (e)), Taxpayer should include the value of the future earnings from Seller's existing XYZ policies in asset Class IV (all section 197 intangibles other than goodwill and going concern value) for purposes of determining the amount of the total consideration which was allocable to the indemnity reinsurance ceding commission..

FACTS

Taxpayer is a life insurance company within the meaning of § 816(a) and is the lead company within X Group. On Date-a, Taxpayer acquired the XYZ business of Seller, which is also a life insurance company within the meaning of § 816(a), for total cash consideration of $a. The sales contract between Taxpayer and Seller included (i) a stock purchase agreement in which Taxpayer acquired 100% of the stock of certain Seller subsidiaries; (ii) an asset transfer agreement in which Taxpayer purchased certain investment assets, computer software, permits and licenses, and other assets associated with Seller's XYZ business; and (iii) an indemnity reinsurance agreement in which Taxpayer assumed 100% of the contract liabilities relating to a block of Seller's existing XYZ policies which were in force on Date-a.

The reinsurance agreement was structured so that all of the potential risks related to Seller's existing XYZ policies were transferred to Taxpayer as a result of the transaction. Pursuant to the terms of the reinsurance agreement, Taxpayer agreed to pay Seller a ceding commission of $b, based on an estimate of future statutory profits on the XYZ policies mutually agreed to by the parties. The ceding commission was paid to Seller as part of the total cash consideration for Seller's XYZ business. In exchange for the ceding commission and Taxpayer's assumption of the contract liabilities, Seller transferred an amount of investment assets equal to the statutory reserves for the XYZ policies, together with the right to all future premiums on the XYZ policies. The reinsurance agreement did not contain any provision allowing Seller to recapture the business at a future date, or to share in the future profits of the XYZ policies (such as through an experience-related refund).

Following the reinsurance agreement, Taxpayer assumed the primary responsibility for administering the XYZ policies, including billing the policyholders for premiums due, paying all claims and benefits, and maintaining the accounting records for the XYZ policies. Seller no longer had any direct relationship with the policyholders for these purposes. Although Taxpayer assumed practically all of Seller's rights and obligations under the XYZ policies, Taxpayer did not reissue the XYZ policies in its own name. The policyholders were not asked to, and have not released Seller from contractual liability for claims or other benefits under the policies. Consequently, under state insurance laws, Seller remained contractually liable to policyholders for payment of claims and benefits under the XYZ policies, although as a practical matter this liability would only mature if Taxpayer's assets are insufficient to cover those contractual obligations.

In connection with the above transactions, Taxpayer and Seller entered into the following series of related agreements:

1. A license agreement, under which Taxpayer acquired the use of Seller's logos and trademarks for a specified period of time.

2. An employment agreement, which allowed Taxpayer to solicit the employment of certain of Seller's producing agents and employees who were involved in the marketing of XYZ policies. These employment contracts were separately negotiated by Taxpayer and the individual agents and employees, with compensation determined at market rates.

3. A administrative services agreement, in which Seller agreed to continue to administer any existing or new XYZ policies for a specified period of time after the transaction until Taxpayer was able to take over these functions. Taxpayer agreed to reimburse Seller for its costs in providing these administrative services.

4. A covenant not to compete, in which Seller agreed to refrain from issuing any new XYZ policies for a specified period of time after the transaction.

In filing its federal income tax return for Taxable Year A, Taxpayer reported the acquisition of Seller's XYZ business, including the assets acquired as a result of the indemnity reinsurance agreement, on Form 8594, Asset Acquisition Statement. On Form 8594, Taxpayer reported a total consideration of $c for the transferred assets, including $d of tax reserves on Seller's existing XYZ policies which Taxpayer agreed to assume in the indemnity reinsurance agreement. On Form 8594, Taxpayer reported the aggregate fair market value of the assets in Class I, II, III, and IV and V as $e. For this purpose, Taxpayer included the $b ceding commission (as specified in the reinsurance agreement) in asset Class IV, all section 197 intangibles other than goodwill and going concern value. Taxpayer allocated the total consideration among each asset class in priority order in accordance with the residual method specified in §§ 338(b) and 1060(a). Because the aggregate fair market of the Class IV assets exceeded the amount of consideration allocable to that asset class, Taxpayer allocated the amount consideration among each of the Class IV assets (including the $b ceding commission) in proportion to its relative fair market value. In this manner, Taxpayer determined a tax basis of $f for the indemnity reinsurance ceding commission.

No portion of the consideration was allocated to assets in the nature of goodwill and going concern value (Class V).

In filing its federal income tax return for Taxable Year A, Taxpayer included the net positive consideration from the indemnity reinsurance agreement (as defined in § 1.848-2(f)) in its net premiums for purposes of determining the amounts capitalized as specified policy acquisition expenses under § 848(a) for the taxable year. Pursuant to § 848(g), Taxpayer treated the amount of consideration allocable to the indemnity reinsurance ceding commission as a currently deductible expense.

You have proposed to redetermine the amount which Taxpayer is treated as having paid or incurred as an indemnity reinsurance ceding commission by applying the principles of § 1.817-4(d)(2), relating to conventional assumption reinsurance transactions, to

determine the acquisition cost of Seller's existing XYZ policies. Under this approach, you would determine the ceding commission by comparing the increase in Taxpayer's tax reserves as a result of the reinsurance agreement to the net value of all of the tangible and intangible assets transferred to Taxpayer in the taxable acquisition (other than any value attributable to the reinsured policies). As a practical matter, this approach places the value of the purchased insurance contracts junior to all other assets which Taxpayer received in the taxable acquisition (including other acquired intangibles, such as workforce in place, licenses and permits, and amounts in the nature of goodwill or going concern value). As a result, any shortfall in the total consideration relative to the aggregate fair market value of the acquired intangibles is subtracted directly against the indemnity reinsurance ceding commission, rather than prorated among each of the acquired intangibles (other than goodwill and going concern value) in accordance with the residual allocation method of §§ 338(b) and 1060(a).

LAW AND ANALYSIS

The issue for which you have requested advice is what method should be used to determine Taxpayer's tax basis in an indemnity reinsurance ceding commission in a situation where the reinsurance agreement was part of a larger transaction in which Taxpayer acquired substantially all of the tangible and intangible assets associated with Seller's XYZ business. Specifically, you have asked whether the amount Taxpayer is considered to have paid or incurred as a ceding commission should be determined in accordance with the principles of Subchapter L, relating to conventional reinsurance transactions, or whether Taxpayer's basis in the ceding commission should be determined by treating the future earnings on Seller's existing XYZ policies as one of the intangible assets acquired in the asset acquisition for which basis would be determined using the residual method specified by the regulations under § 338(b) (§§ 1.338(b)-2T and 1.338(b)-3T) and § 1060(a) (§§ 1.1060-1T(d) and (e)).

In general, reinsurance is a transaction in which one insurance company transfers all or a portion of the risk arising out of an insurance policy or a group of insurance policies that it has underwritten to another insurance company. The insurance company that is the direct writer of the policy and that seeks to transfer risk is referred to as the ceding company, and the insurance company that assumes risk in the transaction is referred to as the assuming company or reinsurer.

Reinsurance transactions may be classified as either indemnity reinsurance or assumption reinsurance transactions. Under indemnity reinsurance, the policyholders have no contractual relationship with the reinsurer and, in fact, the policyholders rarely have any knowledge of the reinsurance transaction. An indemnity reinsurance transaction is strictly a bilateral agreement between the ceding company and the reinsurer. The policyholders continue to remit premiums to the insurance company that issued the policy and look to that company for the payment of benefits. The ceding company remits the reinsurance premium to the reinsurer and looks to the reinsurer for reimbursement with respect to a portion of

claims and benefits on the reinsured policies. Should the reinsurer fail to meet its obligations to the ceding company, the ceding company still has full liability to the policyholder. Tiller and Tiller, Life, Health & Annuity Reinsurance, 12-13 (2d ed. 1995).

By contrast, an assumption reinsurance transaction involves a permanent transfer of insurance liabilities from one company to another company. In an assumption reinsurance transaction, the reinsurer assumes the position formerly occupied by the insurance company that issued the original policy. Thus, the assumption reinsurer assumes the direct obligation to the policyholder and the original insurance company expects to be released from any further obligation to the policyholder. Historically, the terms of an assumption reinsurance agreement were fashioned by the original insurance company and the assuming company, subject only to the approval of the insurance departments of the original insurer and the assumption reinsurer.

In 1994, the National Association of Insurance Commissioners adopted the Assumption Reinsurance Model Act. Prior to the adoption of the Model Act, there had been a number of insolvencies and defaults involving assumption reinsurers which had resulted in a substantial amount of litigation regarding whether the original insurers remained liable if the policyholders had not consented to the transfer of obligors. The purpose of the Model Act was to address the need for specific provisions to be included in assumption reinsurance agreements so that insurers and policyholders would have greater certainty as to the results of these transactions.

The Model Act takes the position that assumption reinsurance is a novation of a previously valid agreement and thus requires the approval of both the policyholder and the insurer. Therefore, the transfer of the insurance obligation to the assuming company would not be held valid if only the original insurer had approved, as had been the case previously. Accordingly, under the Model Act, notification of the assumption reinsurance agreement must be provided to policyholders, agents, and brokers. The policyholders have the right to reject the transfer, although in practice if relatively few object, insurance departments may override such objection and authorize the assumption of all policies for administrative convenience. If the policyholder has not objected in writing after two notices and a specified time period, currently 24 months in the Model Act, the policyholder is deemed to have accepted the transaction. Also, payment of a premium without reserving the right to reject the transfer is deemed to constitute acceptance. The Model Act recognizes one situation where unilateral novation may be effective. If the insurance department of the original insurer's domiciliary state finds the company to be in a hazardous financial condition, the commissioner may transfer the company's in-force business to another carrier without policyholder consent and provide an explanation to the policyholder. See Tiller and Tiller, Life, Health, and Annuity Reinsurance, 308-10.

If Taxpayer had simply reinsured a block of Seller's existing XYZ policies in a conventional reinsurance transaction, instead of reinsuring those policies as part of a larger transaction in which Taxpayer acquired substantially all of the tangible and intangible assets associated with Seller's XYZ business, the amount which Taxpayer would be treated as

having paid or incurred as a ceding commission for the future earnings on the reinsured policies would be determined in accordance with the principles of § 1.817-4(d)(2), relating to assumption reinsurance transactions.

Under the rules for assumption reinsurance transactions, the seller or ceding company is treated as paying a premium or other consideration in order for the reinsurer to assume the contract liabilities. Thus, the ceding company records the transaction by reducing its previously deducted reserves with respect to the reinsured policies, which gives rise to ordinary income under § 803(a)(2). The ceding company is then allowed an offsetting deduction under § 805(a)(6) for the amount of consideration which it pays to the reinsurer for assuming the policy obligations. However, § 1.817-4(d)(2)(i) provides that the ceding company's deduction for this consideration is reduced (but not below zero) by any amount received from the reinsurer in the transaction, and if the amount so received exceeds the consideration which the ceding company pays to the reinsurer for the assumption of the contract liabilities, the ceding company recognizes this excess in ordinary income under § 803(a)(2). Thus, under the principles of § 1.817-4(d)(2), the ceding company must recognizes any gain attributable the sale of the insurance contracts as ordinary income, rather than capital gain.

Correspondingly, the reinsurer includes the amount of consideration which it receives from the ceding company for assuming the insurance contract liabilities as an item of premium income under § 803(a)(1). See § 803(b)(1)(E) (gross amount of premiums includes consideration in respect of assuming liabilities on contracts not issued by the taxpayer). The reinsurer offsets this income inclusion by deducting the amount by which its reserves and similar liabilities are increased as a result of the reinsurance transaction. See § 805(a)(2). If, however, the reinsurer receives an amount of premiums and other consideration from the ceding company which is less than the increase in the reinsurer's reserves resulting from the transaction, § 1.817-4(d)(2)(iii) provides that the reinsurer is treated as (i) having received premiums and other consideration equal to the increase in its reserves, and (ii) having paid a ceding commission or allowance for the reinsured policies equal to the difference between the increase in the reinsurer's reserves as a result of the transaction and the consideration actually received.

In effect, the regulations under § 1.817-4(d)(2) treat an assumption reinsurance transaction as two separate exchanges. In one exchange, the assuming company receives consideration (and thus income) for assuming the applicable contract liabilities in an amount equal to its deduction for increases in reserves as a result of the reinsurance transaction. In the second exchange, the assuming company pays the ceding company an amount equal to the value of the contracts purchased in the transaction. In this manner, the regulations treat any excess of the liabilities assumed by the reinsurer as a result of the reinsurance transaction over the tangible assets received as the acquisition cost of the insurance contracts. Under § 197(f)(5), the reinsurer treats the excess of the amount paid or incurred for an insurance contract in an assumption reinsurance transaction (but not in an indemnity reinsurance transaction), over the amount capitalized under § 848 as a result of such

transaction, as an amortizable section 197 intangible which is amortized ratably over a 15-year period beginning with the month of the acquisition.

Although the provisions of § 1.817-4(d)(2) apply only to assumption reinsurance transactions, the Service took the position in Rev. Rul. 82-69, 1982-1 C.B. 102 that an "up-front" ceding commission in an indemnity reinsurance transaction represents the acquisition cost of a block of business, and thus had to be treated as a deferred expense and amortized over the life of the reinsurance agreement. In Colonial American Life Insurance Co. v. Commissioner, 491 U.S. 244, 1989-2 C.B.110, the Supreme Court concluded that the indemnity reinsurance ceding commissions represent payments to acquire an asset (the future stream of income from the reinsured policies), and therefore should be capitalized and amortized in accordance with general capitalization rules applicable to other businesses.

The Court noted:

> Although indemnity reinsurance is different from assumption reinsurance in some important ways, none of them goes to the function and purpose of the ceding commissions. Whether the reinsurer assumes the direct liability to the policyholder in no ways alters the economic role that the ceding commissions play in both kinds of transactions. The only rational business explanation for the more than $1,500,000 that petitioner paid in ceding commissions to [the ceding company] is that petitioner was investing in the future earnings of the reinsured policies. The ceding commissioners thus are not administrative expenses on the order of agents' commissioners in direct insurance; rather, they represent part of the purchase price to acquire the right to a share of future profits.

1989-2 C.B. at 111.

The method of determining the amount paid or incurred by a reinsurer for the purchase of insurance contracts under the principles of § 1.817-4(d)(2) differs in significant respects from the general rules in which purchase price allocations are made for taxable acquisitions of assets of a going business. In taxable acquisitions generally, the purchaser pays an agreed-upon amount to the seller for all the assets of a going business, rather than separately bargained-for payments for each individual asset. For tax purposes, however, both the purchaser and the seller must allocate the purchase price for the acquisition among each of the assets transferred. The seller must allocate the purchase price among the assets to determine the amount and character of the realized gain or loss on the sale. The purchaser's allocation determines its basis in each asset and affects its amount of allowable depreciation or amortization deductions, its realized gain or loss on a subsequent sale of those assets, and may have other tax consequences. In some cases, and depending on the nature of the assets involved, the seller and the purchaser may have opposing interests regarding the manner in a lump sum purchase price is allocated among the assets transferred.

Sections 338(b) and 1060 address the potential controversies and measurement issues that may arise regarding purchase price allocations by mandating the use of a residual method of allocation. Under the residual method, the assets of a going business, other than goodwill and going concern value, must be placed into distinct asset classes, as follows: (1) Class I - Cash and cash equivalents; (2) Class II - Certificates of deposit, U.S. government securities, readily marketable stock or securities, and foreign currency; (3) All assets not in Class I, II, IV, and V; and (4) Class IV - all section 197 intangibles, except those in the nature of goodwill and going concern value; (5) Class V - section 197 assets in the nature of goodwill and going concern value. The purchase price is then allocated among these asset classes in priority order. Under this allocation scheme, no asset in any class (except the residual class) may be allocated more than its fair market value. If the consideration allocable to a particular asset class is less than the aggregate fair market value of the assets within that class, each asset is allocated an amount of consideration in proportion to its relative fair market value and nothing is allocated to any junior class.

Application of the residual method eliminates the need for a separate determination of the value of goodwill and going concern value. Instead, under the residual method, any "premium" in excess of the total fair market value of the purchased assets (other than goodwill and going concern value) is treated as a payment for goodwill and going concern value. The assignment of goodwill and going concern value to a true residual class reflects the concept that assets in the nature of goodwill and going concern value cannot be valued independently from the purchase price of the overall transaction because these intangible assets are not transferable apart from the business as a whole.

The purchase price allocation rules under § 1060(a) apply to any transfer of assets which constitutes an "applicable asset acquisition." As defined in § 1060(c), an applicable asset acquisition means any transfer, whether direct or indirect, of a group of assets constituting a trade or business with respect to which the purchaser's basis is determined wholly by reference to the consideration paid for such assets. Under § 1.1060-1T(b), a group of assets constitutes a "trade or business" if the use of those assets would constitute a trade or business for purposes of the § 355 divisive reorganization provisions, or if the character of those assets is such that goodwill or going concern value "could under any circumstances" attach to the group (whether or not it does in fact). See § 1.1060-1T(b)(2). According to the regulations, all the facts and circumstances surrounding the transaction are taken into account in determining whether a group of assets constitutes a trade or business. Factors to be considered include related transactions between the purchaser and the seller such as a lease agreement, covenant not to compute, management contract, or other similar agreement between the purchaser or seller (or managers, directors, owners, or employees of the seller); and the excess, if any, of the total consideration over the aggregate book value of the tangible and intangible assets (other than goodwill and going concern value) as shown in the purchaser's financial accounting books and records. See § 1.1060-1T(b)(2).

In the present case, Taxpayer did not merely reinsure a block of Seller's existing XYZ policies through a conventional reinsurance transaction. Rather, the facts relating to

the overall transaction indicate that the indemnity reinsurance agreement was part of a larger taxable acquisition in which Taxpayer acquired substantially all of the tangible and intangible assets associated with the conduct of Seller's XYZ business. In addition to reinsuring a block of Seller's existing XYZ policies, Taxpayer also acquired Seller's agency force, underwriting personnel, computer software and information base, licenses and trademarks, and a portion of Seller's surplus and capital used to support additional writings of XYZ policies. Seller's exit from the XYZ business was so complete that, as part of the overall transaction, Seller executed a covenant not to compete agreeing not to issue additional XYZ policies for a specified period after the transaction.

In the legislative history of § 1060, adopted in 1986, Congress expressed its approval of the use of the residual method under the § 338(b) and required that the same method be used for direct acquisitions of going business pursuant to regulations to be prescribed under § 1060. S. Rep. No. 313, 99th Cong. 2d Sess. 253, 254, (1986), 1986-3 C.B. (Vol. 3) 253-54. In 1993, in connection with the enactment of § 197 (which provides similar treatment for goodwill, going concern value, and other acquired intangibles of a trade or business), Congress indicated that the residual method specified in the regulations under § 338(b) should be modified by making section 197 assets junior to other assets in the allocation scheme. H. Rep. 111, 103rd Cong., 1st Sess. 760, 776 (1993), 1993-3 C.B. 336, 352.

In light of Congressional approval of the residual allocation method for taxable acquisitions, as expressed in the legislative history of §§ 1060 and 197, we believe that application of the principles of § 1.817-4(d) to determine the amount of Taxpayer's basis in the indemnity reinsurance ceding commission would not be appropriate where, as noted above, the reinsurance agreement was part of a taxable acquisition of a going business to which the rules of § 1060 would apply. The principles of § 1.817-4(d)(2) were designed for conventional reinsurance transactions and not for acquisitions of whole businesses with various categories of acquired intangibles (including the possibility of goodwill and going concern value). Indeed, the manner in which the amount paid or incurred by a reinsurer for the purchase of an insurance contract is determined under § 1.817-4(d)(2) generally precludes the possibility of any goodwill or going concern value arising from the transaction. This is because any difference between the liabilities assumed by the reinsurer and the assets received (other than any value attributable to the reinsured contracts) is treated as the acquisition cost of a block of insurance contracts. Therefore, the manner of determining the acquisition cost of a block of insurance contracts under § 1.817-4(d)(2) either precludes the possibility of any goodwill or going concern value arising from the transaction, or treats such goodwill or going concern value as capable of being valued independently from the purchased insurance contracts, which would be contrary to the Congressional intention in enacting §§ 1060 and 197 that goodwill and going concern value be placed in a true residual class (and not valued separately from other assets acquired in the transaction).

According, because Taxpayer's acquisition of Seller's XYZ business constitutes an applicable asset acquisition within the meaning of § 1060(c), Taxpayer is required by

§ 1060(a) to determine the basis of the assets transferred, including the basis allocable to the future earnings on Seller's XYZ policies which were transferred to Taxpayer as a result of the indemnity reinsurance agreement, using the residual allocation method prescribed by the regulations under 338(b) (§§ 1.338(b)-2T and 1.338(b)-3T) and 1060(a) (§ 1.1060-1T(d) and (e)). In applying the residual method, Taxpayer should treat the tax reserve liabilities on Seller's existing XYZ policies which were assumed as a result of the indemnity reinsurance agreement as part of the total consideration for the transferred assets. Correspondingly, Taxpayer should include the value of the future earnings on the Seller's existing XYZ policies which were transferred as a result of the indemnity reinsurance agreement in asset Class IV (all section 197 intangibles other than goodwill and going concern value) for purpose of determining the tax basis assigned to the indemnity reinsurance ceding commission. See §§ 1.338(b)-2T and 1.1060-1T(d)(2)(iv).

DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

Please call , if you have any further questions.