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Insurance Tax Issues in Mergers and Acquisitions: *Identifying and Preserving Value and Avoiding Subchapter L Surprises*

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INSURANCE, n.

An ingenious modern game of chance in which the player is permitted to enjoy the comfortable conviction that he is beating the man who keeps the table.

The Devil's Dictionary, Ambrose Bierce

The provisions of Subchapter L of the Internal Revenue Code[2] pose challenges to companies and tax practitioners alike. Nonetheless, mastery of these provisions is crucial to identifying and preserving value in insurance company transactions. The insurance industry has experienced a significant uptick in mergers, acquisitions, dispositions and restructurings in the last 18 months as compared to recent years. For example, Q4 of 2014 has been described as representing the strongest insurance deals quarter in recent memory, with the momentum continuing into 2015.[3] This activity is influenced by a number of factors, including flat interest rates, consumer demand for new and innovative products, the evolution of the types and nature of risks to be insured (such as cyber security coverage), an aging population, legal and regulatory changes and significant changes to accounting standards and regulatory capital requirements, to name a few.

There are two common, but distinct, misperceptions about the operation of the federal tax rules applicable to insurance companies pursuant to Subchapter L. The first misperception is that Subchapter L operates in a self-contained world, similar in certain respects to other specialized areas such as Subchapter K or Subchapter M. The second misperception is that the provisions of Subchapter L provide traps for the unwary while offering little in the way of return.

Subchapter L does not operate in a vacuum. Insurance companies and insurance company affiliated groups are generally subject to the same tax rules that apply to non-insurance companies and groups. Because the Code layers on a number of specific provisions applicable only to insurance companies, transactions and products, the baseline corporate tax rules are thus observed, revised, augmented, or replaced in connection with transactions involving insurance companies, depending on the circumstances. Some provisions apply only to life insurance companies and certain other provisions apply only to nonlife insurance companies, adding additional complexity. There are provisions applicable to foreign insurance companies and foreign-issued products, and provisions applicable to cross-border insurance company and product transactions.

Some of the provisions are broad in scope, and apply on a fundamental level. For example, insurance companies are required to use the calendar year as their annual accounting period, but may adopt the taxable year of the common parent in connection with the insurance company's joinder in the consolidated return.[4] In addition, an ''insurance company'' is a per se corporation for federal tax purposes.[5] So, while a group of affiliated entities that includes an insurance company may be permitted to ''check the box'' in

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[2] Unless otherwise specified, all ''Section'' or ''§'' references refer to the Internal Revenue Code of 1986, as amended, and the regulations thereunder.

[3] *See top issues: An annual report, Volume 7, 2015 ''The insurance industry in 2015,''* PWC.

[4] §843.

[5] Reg. §301.7701-2(b)(4).

connection with the tax classification of certain non-insurance companies within the group, an insurance company is always classified as a corporation for federal tax purposes. Other provisions are extraordinarily narrow. For example, an election can be made by a qualified small nonlife insurance company to be taxed only on its investment income.[6]

The provisions of Subchapter L can be leveraged in conjunction with structuring alternatives, and they can illuminate promising due diligence pathways to hidden value or hidden risks. As a result, Subchapter L's numerous insurance-specific provisions often affect both the structure of the deal and the ultimate deal value, sometimes materially. Stated differently, a comprehensive understanding of the rules can provide both negotiating leverage and more finely tuned value assumptions. Conversely, the failure to recognize and appreciate the application of these provisions to a deal structure can prove costly. A comprehensive discussion of each of these provisions is beyond the scope of this article. Instead, the provisions more commonly encountered will be identified and described, along with due diligence or practice tips where appropriate.

CHALLENGE 1: DETERMINING INSURANCE COMPANY STATUS

"What's another word for Thesaurus?"

— Steven Wright

Although the answer might seem obvious, the first question that must be addressed is whether one is in fact dealing with an insurance company for federal tax purposes. An "insurance company" is "any company more than half of the business of which during the taxable year is the issuing of insurance or annuity contracts or the reinsurance of risks underwritten by insurance companies."[7] Whether an insurance company is taxed as a life insurance company under Part I of Subchapter L or a nonlife insurance company under Part II of Subchapter L is determined by the qualification fraction of §816(a). Generally speaking, a "life insurance company" is an insurance company whose life insurance reserves plus unearned premiums and unpaid losses on noncancellable life, accident, or health policies not included in life insurance reserves, exceed 50% of its total reserves.

The fact that there is no definition in either the Code or the Treasury Regulations as to what constitutes "insurance" for federal tax purposes creates yet another challenge for tax advisors.[8] The analysis of whether an arrangement constitutes insurance has its roots in the seminal case of *Helvering v. LeGierse*.[9] In that case, an 80-year old woman acquired a single premium life insurance policy on her life, and simultaneously acquired an annuity that provided for periodic payments for life from the same insurance company. The arrangement was thought to be beneficial to Ms. LeGierse because it would enable her estate to exclude the life insurance proceeds from estate tax. Although the life insurance policy and the annuity were issued and treated as separate contracts by the parties, the insurance company refused to issue the life insurance policy without also issuing the annuity.[10]

The Supreme Court found that the two contracts had to be considered together to properly reflect the substance of the arrangement, because the insurer would not have issued the life insurance contract without also issuing the annuity. The Court stated that "[h]istorically and commonly insurance involves risk-shifting and risk-distributing. . . . That these elements of risk-shifting and risk-distributing are essential to a life insurance contract is agreed by courts and commentators."[11] Certain language in the opinion has been seized upon by the Internal Revenue Service (the "IRS") for the argument that, in order to be treated as insurance for federal tax purposes, an arrangement must constitute insurance in its commonly accepted sense:

> Congress used the word "insurance" [in the statute] in its commonly accepted sense. Implicit in this provision is acknowledgment of the fact that usually insurance payable to specific beneficiaries is designed to shift to a group of individuals the risk of premature death of the one upon whom the beneficiaries are dependent for support.[12]

To support its contention that the arrangement must constitute "insurance in the commonly accepted sense," the IRS points to cases such as *Ocean Drill-*

[6] §831(b).

[7] §816(a), §831(c).

[8] Note, however, that "life insurance" is defined under §7702. The definition is mechanical and involves various calculations designed to kick out products that are overly investment-oriented. There are some circumstances under which a variable life insurance contract could satisfy §7702 and yet not be treated as a life insurance contract discussed below.

[9] 312 U.S. 531 (1941).

[10] No medical examination was required before the policy was issued. *Helvering v. LeGierse,* 312 U.S. at 537.

[11] *Helvering v. LeGierse*, 312 U.S. at 539.

[12] *Helvering v. LeGierse*, 312 U.S. at 541.

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ing & Exploration Co. v. United States,[13] and *AMERCO, Inc. v. Commissioner*.[14] Notwithstanding subsequent case law quoting the relevant language concerning ''commonly accepted sense,'' whether or not *Helvering v. LeGierse* can be read to actually confer a separate test above and beyond risk-shifting and risk distribution is an open question. This issue was implicitly addressed by the United States Tax Court in *R.V.I. Guaranty Co., Ltd. and Subsidiaries v. Commissioner*.[15]

Other facts to be taken into account are that the risk transferred must be the risk of an economic loss, *Allied Fidelity Corp. v. Commissioner*,[16] and must contemplate the fortuitous occurrence of a stated contingency, *Commissioner v. Treganowan*.[17] Moreover, the IRS has explained in published guidance, an insurance risk must not be merely an investment or business risk.[18]

Risk shifting occurs if a person facing the possibility of an economic loss transfers some or all of the financial consequences of the potential loss to the insurer. Stated differently, a loss by the insured does not affect the insured because the loss is offset by a payment from the insurer. For U.S. federal income tax purposes, risk shifting does not occur if the event underlying the transfer has already occurred.[19]

Risk distribution incorporates the statistical phenomenon known as the law of large numbers. Distributing risk ''allows the insurer to reduce the possibility that a single costly claim will exceed the amount taken as a premium and set aside for the payment of such a claim. Insuring many independent risks in return for numerous premiums serves to distribute risk.''[20] The IRS has explained that risk distribution necessarily involves the pooling of premiums from multiple independent policyholders and, thus, arrangements that involve an insurer who contracts with only one policyholder do not qualify as insurance contracts.[21]

Courts have also recognized that risk distribution necessarily entails a pooling of premiums, so that a potential insured is not in significant part paying for its own risks.[22]

CHALLENGE 2: DETERMINING WHICH STRUCTURE BEST MEETS BUSINESS AND ECONOMIC GOALS

''How do you make money?

Spinoffs, split-ups, liquidations, mergers and acquisitions.''

— Mario Gabelli

There are a number of different ways to acquire or dispose of an insurance business, and as the industry continues to evolve, companies' needs and business objectives evolve as well. In addition, the limitations and restrictions imposed by legal and regulatory provisions often demand creative approaches to structuring transactions. For example, because insurance companies are licensed by the individual states, legal entities hold these licenses and thus the legal entity must be acquired to acquire the license. If the acquirer already holds the necessary licenses, the acquirer may prefer not to acquire the legal entity, but perhaps just a specific category of business. As a result, transactions can be structured around a block of contracts, a line of business, or a corporate entity, depending on the needs and commercial objectives of the parties.

Stock Acquisitions

In the context of a stock acquisition of an insurance company, as is the case for non-insurance companies, the parties will have greater flexibility in structuring the transaction if the target is a private company, or a subsidiary of a public company. Such circumstances provide opportunities to negotiate customized transaction structures with varied consideration, and, unlike public company transactions, provide the possibility of a tax basis step-up in assets acquired with a single level of tax. Stock acquisitions of insurance compa-

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[13] 988 F.2d 1135, 1153 (Fed. Cir. 1993).

[14] 979 F.2d 162 (9th Cir. 1992).

[15] *R.V.I. Guaranty Co., Ltd. and Subsidiaries v. Commissioner*, 145 T.C. No. 9 (2015).

[16] 572 F.2d 1190, 1193 (7th Cir. 1978).

[17] 183 F.2d 288, 290-291 (2d Cir. 1950).

[18] *See* Rev. Rul. 2007-47, 2007-29 I.R.B. 127. *See also* CCA 201511021. *But see R.V.I. Guaranty Co., Ltd. and Subsidiaries v. Commissioner*, 145 T.C. No. 9 (2015). The IRS had argued that the taxpayer's residual value insurance contracts were not ''insurance'' for federal income tax purposes. The Tax Court concluded that the policies issued by the taxpayer did indeed qualify as insurance policies for U.S. federal income tax purposes. In reaching its conclusion, the court held that the risks covered by R.V.I. are insurance risks and that the policies otherwise meet the tax test for insurance treatment.

[19] *See* Rev. Rul. 89-96, 1989-2 C.B. 114; Rev. Rul. 2007-47, 2007-29 I.R.B. 127.

[20] *Clougherty Packing Co. v. Commissioner*, 811 F.2d 1297, 1300 (9th Cir. 1987); Rev. Rul. 2009-26, 2009-38 I.R.B. 366.

[21] Rev. Rul. 2009-26, above; *see also* Rev. Rul. 2014-15, 2014-22 I.R.B. 1095.

[22] *Humana, Inc. v. Commissioner*, 881 F.2d 247, 257 (6th Cir. 1989). *See also Ocean Drilling and Exploration Co.*, 988 F.2d at 1153 (''Risk distribution involves spreading the risk of loss among policyholders.''); *Beech Aircraft Corp. v. United States*, 797 F.2d 920, 922 (10th Cir. 1986) (''[R]isk distributing means that the party assuming the risk distributes his potential liability, in part, among others.'').

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nies can take the form of tax-free reorganizations or taxable stock acquisitions.

Net Operating Losses, Built-in Losses and Built-in Gains

One important consideration in valuing and structuring insurance company transactions is the potential limits on ability of the acquirer (or surviving corporation) to utilize losses attributable to periods before the change in ownership occurred. Section 382 provides rules regarding a corporation's ability to offset its taxable income in years following an ''ownership change'' with losses attributable to periods before the change in ownership occurred. Once an ownership change occurs, §382 does not impair an NOL carryover itself, but restricts the amount of income that can be offset by pre-change NOL carryovers. Because pre-change losses may offset post-change income only to the extent of the ''§382 limitation,'' the computation of such amount is of critical importance.

The §382 limitation is an amount that is equal to the value of the loss corporation immediately prior to the ownership change multiplied by the applicable federal long-term tax-exempt rate. Both the value of old loss corporation and the rate should be determinable as of the change date, thus, the amount of the §382 limitation may be calculated at that time. It is important to note that if the business of the corporation is discontinued within two years of the change date, the §382 limitation is zero. In general, the amount of the §382 limitation remains constant throughout the carryover period, except that adjustments may be made under circumstances described in more detail below.

Special rules apply if an old loss corporation has a net unrealized built-in gain (''NUBIG'') or a net unrealized built-in loss (''NUBIL''). In general, subject to certain threshold requirements, built-in gains may be offset by pre-change losses as if they were recognized before the change date. However, built-in losses are subject to the same limitations as pre-change losses. To determine whether the special rules for built-in gains or losses apply, one must first determine whether the loss corporation has a NUBIG or a NUBIL.

A loss corporation has a NUBIG if the excess of the fair market value of its assets immediately before an ownership change over those assets' aggregate adjusted basis exceeds the lesser of $10 million or 15% of the fair market value of the corporation's assets on the change date (the ''threshold''). In such a case, the §382 limitation is increased to the extent any such built-in gain is recognized during the five-year period beginning on the change date (the ''recognition period''). Conversely, a loss corporation has a NUBIL if the excess of the aggregate adjusted basis of its assets over such assets' fair market value exceeds the threshold above, and any such built-in loss recognized during the recognition period is treated as pre-change loss that can offset post-change taxable income only to the extent of the available §382 limitation.

Once the value of the loss corporation is determined under the parameters described above, opportunities still exist for a loss corporation to increase its §382 limitation in years following the ownership change. One such opportunity is for a loss corporation that is in a NUBIG position on the change date to sell an asset that was considered a ''built-in gain'' asset on the ownership change date within the five-year period following the change date. Under these circumstances, the §382 limitation will be increased by the amount of the recognized built-in gain, thus permitting more income to be offset by the increased amount of available NOL carryforwards.

Assuming the old loss corporation is in a NUBIG position, the §382 limitation for any ''recognition period taxable year'' is increased by the ''recognized built-in gains'' (''RBIG'') for the tax year. The term ''recognition period taxable year'' means ''any taxable year any portion of which is in the recognition period [defined above].'' Note that RBIG is computed on an *asset-by-asset basis* whereas NUBIG is determined on an *aggregate basis*. The term RBIG means any gain recognized during the recognition period on the disposition of any asset, but only to the extent the new loss corporation establishes (i) that the disposed asset was held by the old loss corporation immediately before the change date; and (ii) the recognized gain does not exceed the excess of the fair market value of the disposed asset on the change date over its adjusted basis as of such date. Thus, if a new loss corporation plans to avail itself of the eased restrictions on RBIG, records must be prepared that identify the assets held as of the change date. In addition, evidence to prove the value of each asset as of the change date must also be collected. This may require a detailed appraisal of assets.

Notice 2003-65 — Calculation Safe Harbors for Built-in Items

On September 12, 2003, the IRS and Treasury published a taxpayer favorable Notice providing interim guidance regarding the treatment of built-in gains and losses under §382(h).[23] In general, the Notice provides that a loss corporation may use either of two methods as safe harbors in determining the amount of its RBIG or RBIL for purposes of §382(h): the §1374 approach (the ''1374 Approach''); or the §338 approach (the ''338 Approach''). A taxpayer may not use elements of both approaches, however, for the same

[23] *See* Notice 2003-65, 2003-40 I.R.B. 747 (the ''Notice'').

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ownership change. The Notice establishes these two methods as safe harbors, not the exclusive means of identifying built-in items for purposes of §382(h). The use of alternative methods, however, will be subject to review by the IRS on a case-by-case basis. The Notice provides that taxpayers may rely on the guidance provided therein until the IRS and Treasury issue temporary or final regulations under §382(h).[24]

Under the Notice, both the 1374 Approach and the 338 Approach utilize the hypothetical sale approach in calculating NUBIG or NUBIL, meaning the net amount of gain or loss that would be recognized in a hypothetical sale of the loss corporation's assets to a third party for fair market value immediately before the ownership change. The amount of the NUBIG or NUBIL is calculated as follows:

1. Determine the amount that would be realized if immediately before the ownership change the loss corporation had sold all of its assets, including goodwill, at fair market value to a third party that assumed all of its liabilities.

2. The gross amount under 1. is then:
   a. Decreased by the sum of the loss corporation's aggregate adjusted basis in its assets and the amount of any deductible liabilities that would be included in the amount realized on the hypothetical sale;
   b. Increased or decreased by the corporation's §481 adjustments that would be taken into account on a hypothetical sale; and
   c. Increased by any recognized built-in loss that would not be allowed as a deduction under §382, §383, or §384 on the hypothetical sale.

The amount by which the above result exceeds $0 is the loss corporation's *NUBIG*; the amount by which $0 exceeds this result is the loss corporation's *NUBIL*.

Although the NUBIG/NUBIL determination described above is used in both the 1374 Approach and the 338 Approach, the approaches handle RBIG/RBIL determinations differently. In general, and as described in more detail below, the 1374 Approach is the better choice for a corporation in a NUBIL Position, and the 338 Approach is a better choice for a corporation a NUBIG Position.

The 1374 Approach

The 1374 Approach generally treats items as "attributable to the pre-change period" only if an accrual-method taxpayer would have included the item in income or been allowed a deduction for it before the change date. The amount of gain or loss recognized during the recognition period on the sale or exchange of an asset is RBIG or RBIL, respectively, subject to the limitations described in §382(h)(2)(A) or §382(h)(2)(B). The sum of the RBIG or RBIL (including deductions that are treated as RBIL as described below) attributable to an asset cannot exceed the unrealized built-in gain or loss in that asset on the change date. Because this approach restricts the scope of items treated as built-in, loss corporations with NUBILs generally will opt to apply it, while loss corporations with NUBIGs generally will not derive significant benefit from its use.

In general, the 1374 Approach does not treat income from a built-in gain asset during the recognition period as RBIG because such income did not accrue before the change date. The 1374 approach treats taxable cancellation of indebtedness ("COD") income recognized during the first 12 months following the ownership change on debt outstanding on the change date as built-in gain, and treats a bad debt deduction recognized during the first 12 months following the ownership change due to a creditor position held on the change date as a built-in loss.

Under the Notice, any reduction of tax basis under §108(b) and §1017 that occurs as a result of excluded COD income realized during the first 12 months following the ownership change is treated as if it occurred immediately before such change, so that a subsequent disposition of such asset may be treated as RBIG (although such basis reduction does *not* affect NUBIG or NUBIL). It is important to note that the Notice addresses COD income only in the context of the determination of the amount of built-in gain recognized during the recognition period. The Notice does not explicitly address whether COD income is includible in the computation of NUBIG and NUBIL.

The 1374 Approach departs from the tax accrual rule and the regulations under §1374 in its treatment of amounts allowable as depreciation, amortization, or depletion (collectively, "amortization") deductions during the recognition period. Except to the extent the loss corporation establishes that the amount is not attributable to the excess of an asset's adjusted basis over its fair market value on the change date, these amounts are treated as RBIL, regardless of whether they accrued for tax purposes before the change date. However, a loss corporation may use any reasonable method to establish that the amortization deduction amount is not attributable to an asset's built-in loss on the change date.

The 338 Approach

The 338 Approach as it is less restrictive than the 1374 Approach vis a vis built-in gain assets and COD income. Under the 338 Approach, *NUBIG or NUBIL*

[24] As this article went to press, no temporary or final regulations have been issued.

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is determined in the same manner as the 1374 Approach. Accordingly, unlike the case in which a §338 election is actually made, contingent consideration (including a contingent liability) is taken into account in the initial calculation of NUBIG or NUBIL, and no further adjustments are made to reflect subsequent changes in deemed consideration. However, this approach identifies *RBIG and RBIL* items by comparing a loss corporation's actual items of income, gain, deduction and loss with those that would have resulted had a §338 election been made for a hypothetical purchase of all of the loss corporation's outstanding stock on the change date. Essentially, the 338 Approach treats a loss corporation's built-in gain assets as generating RBIG, even if they are not disposed of during the recognition period.

Similar to the 1374 Approach, if a loss corporation recognizes taxable COD income attributable to pre-change items, all or a portion of the amount recognized constitutes RBIG. Unlike the 1374 Approach, the amount of recognized COD income treated as RBIG is limited to an amount equal to the excess of the adjusted issue price of the discharged debt over the fair market value of the debt on the change date. In addition, unlike the 1374 Approach, the 338 Approach is *not* bound by the 12-month recognition limit. Thus, all COD income realized during the recognition period related to pre-change debt may be taken into account in calculating RBIG, except to the extent that the fair market value of the debt has declined further since the change date. Any reduction of tax basis under §108(b)(5) and §1017(a) that occurs as a result of excluded COD income realized during the recognition period is taken into account when measuring RBIG or RBIL, to the extent of the excess of the debt's adjusted issue price over its FMV on the change date. However, the reduction of tax basis does not affect the measurement of overall NUBIG or NUBIL under §382(h)(3). The Notice addresses COD income only in the context of the determination of the amount of built-in gain recognized during the recognition period, and does not explicitly address whether COD income is includible in the computation of NUBIG and NUBIL.

For loss corporations with a NUBIL, the 338 approach treats as RBIL certain deductions of the loss corporation. In particular, with respect to an asset that has a built-in loss on the change date, the 338 approach treats as RBIL the excess of the loss corporation's actual allowable cost recovery deduction over the cost recovery deduction that would have been allowable to the loss corporation with respect to such asset had an election under §338 been made with respect to the hypothetical purchase.

Section 338(h)(10) Elections

As discussed in more detail below, it may be desirable for the parties to make a joint election under §338(h)(10) in connection with a taxable stock transaction. In general, if a target company is being acquired from an affiliated group, an election pursuant to §338(h)(10) allows the parties to recognize the gain inherent in the underlying target assets instead of recognizing gain on the sale of the target stock. A §338(h)(10) election treats the sale of target stock as a deemed sale of ''old'' target assets to ''new'' target, followed by a liquidation of ''old'' target. Target shareholders are treated as if they received the sales proceeds from the complete liquidation of ''old'' target. Thus, target shareholders generally do not recognize any gain or loss on the deemed liquidation.[25]

From the acquirer's perspective, the election allows the acquirer to purchase shares of a target, yet receive a ''step-up'' in the tax basis of the target assets as if assets were acquired. As a result, a §338(h)(10) election is generally preferable for buyers where the target has appreciated assets. Sellers may prefer such an election where a stock sale without an election would present a loss disallowance under Reg. §1.1502-36, or where inside asset basis exceeds outside stock basis.

It is important to recognize that the Treasury Regulations under §338 provide specific rules with respect to stock acquisitions involving insurance targets. If the acquirer and the seller agree to jointly make a §338(h)(10) election, the stock sale is treated as the deemed sale of target's assets or, more specifically, the deemed sale of target's insurance contracts. Reg. §1.338-1(a)(2). This deemed sale of insurance contracts is treated for U.S. federal income tax purposes as an assumption reinsurance transaction between old target, as the ceding company, and new target as the reinsurer or acquiring company. Reg. §1.338-1(a)(2), §1.338-11(c). Old target recognizes gain or loss on the deemed sale of its assets based on the ''aggregate deemed sales price'' (''ADSP'') among its assets. Generally, the ADSP for target is the amount for which old target is deemed to have sold all of its assets in the deemed asset sale. Reg. §1.338-4(a). ADSP is allocated among target's assets in accordance with Reg. §1.338-6. For purposes of Reg. §1.338-11(b)(1), old target's tax reserves (as opposed to statutory reserves) are a liability of old target taken into account in determining ADSP. Old target's tax reserves are the reserves for U.S. federal income tax purposes of any insurance, annuity, and reinsurance contracts deemed sold by old target to new target in the deemed asset sale.[26]

New target takes a basis in the assets pursuant to an allocation of ''adjusted grossed-up basis''

[25] §332.

[26] Reg. §1.338-11(b)(1).

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(“AGUB”).[27] AGUB is the amount for which new target is deemed to have purchased all of its assets in the deemed sale under §338(a)(2).[28] AGUB is allocated among target’s assets pursuant to the rules set forth in Reg. §1.338-6; Reg. §1.338-11(b)(1). For purposes of Reg. §1.338-11(b)(1), old target’s tax reserves are also a liability of old target taken into account in determining AGUB.

Under Reg. §1.338-11(c)(2), in a §338(h)(10) transaction or applicable asset acquisition (discussed below), the amount of the assets deemed transferred to the acquirer as a reinsurance premium with respect to the assumption of insurance reserves will always equal the amount of the reserves for federal income tax purposes. All other assets transferred are considered to have been sold for the purchase price plus the remainder of the assumed liabilities. Accordingly, new target does not recognize income on the transaction, but new target may take a proportional reduced basis in the assets on which income may be recognized at a later time.

Generally, the Treasury Regulations provide rules for allocation of ADSP and AGUB based on the relative FMV of the assets. “For purposes of allocating AGUB and ADSP under Reg. §1.338-6 and §1.338-7 the [FMV] of a specific insurance, reinsurance or annuity contract or group of insurance, reinsurance or annuity contracts (insurance contracts) is the amount of the ceding commission a willing reinsurer would pay a willing ceding company in an arm’s length transaction for the reinsurance of the contract if the gross reinsurance premium for the contracts were equal to old target’s tax reserves for the contracts.”[29] Under Reg. §1.338-11, old target is deemed to receive a ceding commission in an amount equal to the ADSP allocated to the acquired contracts, and the new target is deemed to pay a ceding commission in an amount equal to the amount of AGUB allocated to the acquired contracts.[30] This approach is in contrast to the mere reinsurance model set forth in Reg. §1.817-4, as discussed below.

In addition to the usual diligence performed in connection with the decision as to determine whether it is desirable to make a §338(h)(10) election (i.e., seller’s tax basis in target stock, target’s inside asset tax basis, the ability to utilize any §197 intangible, whether target has tax attributes that can be utilized, etc.), other considerations apply in the context of an insurance company target. For example, the parties need to analyze the consequences of the assumption reinsurance transaction, including consequences under the §848 rules, discussed below. In addition, other technical rules under the §338 Treasury Regulations that are beyond the scope of this article may be applicable (e.g., rules with respect to §846(e) elections, triggering of policyholder surplus accounts, special loss discount accounts under §847, etc.) and therefore should also be considered.

Reinsurance Transactions and Asset Acquisitions

Reinsurance transactions often serve as the vehicle for acquiring or disposing of insurance business. There are two basic types of reinsurance: assumption reinsurance and indemnity reinsurance. In assumption reinsurance, an insurer assumes all or a portion of the insurance and annuity risks or liabilities of another insurer by stepping into the shoes of the ceding company to become directly and primarily liable to the insured, beneficiary, or policyholder under the policies and contracts subject to the reinsurance transaction. Reg. §1.809-5(a)(7)(ii) defines assumption reinsurance as “an arrangement whereby another person (the reinsurer) becomes solely liable to the policyholders on the contracts transferred by (the ceding company). Such term does not include indemnity reinsurance or reinsurance ceded.”

In an indemnity reinsurance transaction, the ceding company remains directly liable to the policyholders. The reinsurer in an indemnity reinsurance transaction agrees to indemnify the other insurer for all or a portion of the insurance and annuity risks or liabilities of the ceding company, and as such an indemnity reinsurer does not become directly liable to policyholders. As a result of the distinctions between the two transactions, an assumption reinsurance transaction is treated as a sale of the reinsured policies, whereas an indemnity reinsurance transaction is the purchase of insurance protection from a reinsurer.[31]

Reinsurance transactions must be analyzed under circumstances suggesting an applicable asset acquisition, discussed below, has occurred. The focus of the analysis is generally on whether there is a transfer of goodwill or going concern value to the assuming company. The transfer of an insurance business will be deemed to be an applicable asset acquisition when the “purchaser acquires significant business assets, in addition to insurance contracts, to which goodwill and

[27] Reg. §1.338-11(b)(2).

[28] Reg. §1.338-5(a).

[29] Reg. §1.338-11(b)(2).

[30] Reg. §1.338-11(c)(3).

[31] *Oxford Life Ins. Co. v. United States*, 790 F.2d 1370, 1376 (9th Cir. 1986) (citing *Beneficial Life Ins. Co. v. Commissioner*, 79 T.C. 627, 645-46 (1982), *nonacq.* 1984-2 C.B. 1).

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going concern value could attach."[32] However, "mere reinsurance" of insurance contracts by an insurance company does not necessarily result in an applicable asset acquisition for purposes of §1060.[33] In the case of an applicable asset acquisition, the rules under Reg. §1.338-11 generally will apply regardless of whether the transaction involves indemnity reinsurance or assumption reinsurance.

As discussed above, if a target in a §338 transaction is an insurance company, the deemed sale of insurance contracts is treated as an assumption reinsurance transaction between old target as the ceding company and new target as the acquiring company.[34] Reg. §1.338-11 provides rules on how to treat exchanges of consideration between the ceding company and the acquiring company (i.e., the reinsurer). Reg. §1.338-11(c)(2) and §1.338-11(c)(3) cross-reference Reg. §1.817-4(d)(2) for the rules regarding how the ceding company and the reinsurer must treat the premiums and the ceding commission. Under Reg. §1.817-4(d)(2), the reinsurer is treated as receiving income from the ceding company equal to the value of the consideration received from the ceding company, and a corresponding deduction is allowed for the ceding company for the net amount of consideration provided to the reinsured.

Reg. §1.338-11 modifies these subchapter L provisions by deeming the gross amount of premium paid by the ceding company to the reinsurer in the assumption reinsurance transaction to be equal to the ceding company's closing reserve liability.[35] As discussed above, this approach eliminates the possibility of immediate income to the reinsurer on the deemed assumption reinsurance. Reg. §1.338-11 also modifies the subchapter L provisions by dictating the use of the residual method to determine the amount of any ceding commission.

Applicable Asset Acquisitions

Applicable asset acquisitions are defined as any direct or indirect transfer of a group of assets that constitute a trade or business in the hands of either the purchaser or the seller, and the purchaser's basis in the assets is determined wholly by reference to the consideration paid.[36] A group of assets constitutes a trade or business if the use of such assets would constitute an active trade or business for the purposes of §355 or the assets are of such a character that "[g]oodwill or going concern value could under any circumstances attach to such group." [37]

Goodwill is generally defined as the value of a trade or business attributable to a party's "expectancy of continued patronage" as a result of, for example, the party's name or reputation.[38] Going concern, on the other hand, is the additional value that would attach to property because it is an integral part of an ongoing business activity.[39] For example, if a trade or business would continue to generate business on an uninterrupted basis notwithstanding that the business was sold from one owner to another owner, the trade or business would have going concern value.[40]

The determination of whether assets have goodwill or going concern value (such that they would be deemed to constitute a trade or business) must be made based on the facts and circumstances with respect to each particular transaction.[41] Factors to be included within this analysis include the presence of intangible assets, the existence of an excess of total consideration paid over the book value of the tangible and intangible assets purchased, and certain transactions related to the transfer, including a lease, license, covenant not to compete or other related transactions between the buyer and the seller.[42]

If the parties conclude that an applicable asset acquisition is present, the acquired assets in an applicable asset acquisition are divided into seven classes of assets. Consideration paid for the acquired assets is allocated to each class of assets according to the residual method.[43] The residual method first strips out the Class I assets — cash and cash equivalent assets — from the consideration.[44] Any remaining consideration is then allocated among the assets by ascending class type in an amount not in excess of the FMV of the assets within each class on the date of transfer.[45] If the consideration that is being allocated to a specific class is insufficient to allocate to each asset within that class, the consideration is allocated to the assets within that class in an amount in proportion to the FMV of the individual assets.[46]

Both the seller and the buyer involved in an applicable asset acquisition must report the overall consideration for the transaction and the allocation of the

[32] Reg. §1.1060-1(b)(9).
[33] *Id.*
[34] Reg. §1.338-11(c)(1).
[35] Reg. §1.338-11(c)(2).
[36] §1060(c); Reg. §1.1060-1(b)(1).
[37] Reg. §1.1060-1(b)(2)(i).
[38] Reg. §1.1060-1(b)(2)(ii).
[39] *Id.*
[40] *Id.*
[41] Reg. §1.1060-1(b)(2)(iii).
[42] Reg. §1.1060-1(b)(2)(iii)(A)–§1.1060-1(b)(2)(iii)(C).
[43] Reg. §1.1060-1(a)(1).
[44] Reg. §1.338-6(b)(1).
[45] Reg. §1.338-6(b)(2)(i).
[46] *Id.*

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consideration among the assets transferred to the IRS on Form 8594, *Asset Acquisition Statement Under Section 1060*. Reg. §1.1060-1(e)(1)(ii)(A). Form 8594 is filed with each of the seller and the buyer's respective income tax returns for the taxable year in which the assets were sold. *Id.* Typically, language is added to an asset purchase agreement that addresses the purchase price allocation requirement and the requisite reporting, and provides that the parties agree not to take any position inconsistent with the treatment of the transaction as an applicable asset acquisition.

Neither the Code nor the Treasury Regulations require that a purchase price allocation provision be included in a purchase agreement. If, under a sale of assets, one party concludes that an applicable asset acquisition is not present, then that party will typically advocate not to include purchase price allocation language in the purchase agreement that would require it to file a Form 8594. It is generally more desirable for the parties to reach agreement as to the proper characterization. This is because if a Form 8594 is filed by only one party, this could suggest to the IRS the potential existence of whipsaw positions. In that event, the IRS would want to subject the transaction to increased scrutiny in order to protect the government's interests.

The treatment of the ceding commission will vary depending on whether the reinsurance is affected via assumption reinsurance or indemnity reinsurance, and depending on whether the insurance contracts are subject to the deferred acquisition (''DAC'') rules of §848. In an assumption reinsurance transaction, assuming the contracts are not subject to DAC, the ceding commission is treated as a §197 intangible and amortized over 15 years.[47] In contrast, in an indemnity reinsurance transaction where the contracts are not subject to DAC, the ceding commission is capitalized over the useful life of the acquired contracts pursuant to *Colonial American Life Ins. Co. v. Commissioner*.[48] If the contracts pursuant to the reinsurance transaction are subject to DAC, then to the extent such contracts are reinsured via assumption reinsurance, the ceding commission in excess of the DAC amount attributed to the reinsured contracts is treated as a §197 intangible and amortized over 15 years.

Until recently, there was somewhat of an open issue as to how to treat the ceding commission in excess of the DAC amount in connection with indemnity reinsurance that is not ''mere reinsurance.'' The question was whether an indemnity reinsurance transaction that is part of an applicable asset acquisition should be treated as an assumption reinsurance transaction for §197 purposes, resulting in a 15-year amortization of the ceding commission versus an immediate deduction or capitalization over the life of the business. Although Reg. §1.1060-1(c)(5) provides a cross-reference to Reg. §1.338-11(a)–§1.338-11(d), this cross-reference should not automatically convert an indemnity reinsurance transaction that is part of a §1060 applicable asset transaction into an assumption reinsurance agreement for U.S. federal income tax purposes. The fact that Reg. §1.1060-1(c)(5) instructs that an insurance contract is a Class VI asset regardless of whether it is a §197 intangible suggests that the insurance in-force may be a §197 intangible, or it may not.

Practitioners had expressed that, while not free from doubt, the better view was that the cross-reference in the §1060 Treasury Regulations to the §338 Treasury Regulations should be read as providing for a purchase price allocation under the §338 Treasury Regulations, and not read as requiring an indemnity reinsurance that is part of an applicable asset acquisition to be treated as assumption reinsurance for §197 purposes. A recent Chief Counsel Advice memorandum, however, adopts the former interpretation. In CCA 201501011, the Chief Counsel's Office explained:

> The rules describing the residual method are clear that an indemnity reinsurance contract is a Class VI, §197 intangible. They are also clear that they treat §338 and §1060 acquisitions as deemed assumption reinsurance arrangements. In general, the ceding commission on assumption reinsurance contracts are capitalized over ten years under §848 then amortized over fifteen under §197.
>
> After it issued the proposed regulations, the Service received comments asking that the final §338 regulations clarify that §197 amortization does not apply to deemed assumption reinsurance arrangements allowing an indemnity reinsurer an immediate deduction of the ceding commission under §848(g). The final regulations do not provide this immediate deduction and allowing it would be inconsistent with Congressional intent. (citations omitted).

This apparent flip in position will certainly affect deal pricing going forward. In addition, it certainly could be perceived as retroactively impacting deals involving assumption reinsurance transactions that have long closed.

Renewal Rights Agreements

If a stock purchase is not feasible, and reinsurance is not desirable under the circumstances, a renewal

[47] §197(f)(5).

[48] 491 U.S. 244 (1989).

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rights agreement provides an alternative structure for acquiring the future rights to business. A renewal rights arrangement involves the sale by one insurance company of all of its rights, title and interest in the renewals of contracts in-force to another insurance company. These transactions may also involve the acquisition of certain employees, covenants not to compete, or other assets related to such contracts. Because a sale of renewal rights is treated as a sale of assets, there may be an issue for U.S. federal income tax purposes as to whether the sale qualifies as an applicable asset acquisition. A sale of renewal rights by itself would probably not be deemed to be an applicable asset acquisition, but if the sale were to include certain other arrangements, including a license, a covenant not to compete, and a number of intangibles, then the sale does begin to resemble an applicable asset acquisition. However, as discussed above, each transaction must be evaluated on its own facts and circumstances.

CHALLENGE 3: IDENTIFYING AND ANALYZING INSURANCE-SPECIFIC ADJUSTMENTS

"Confidence is what you have before you understand the problem."

— Woody Allen

Specified Policy Acquisition Expenses (Deferred Acquisition Costs)

Section 848 requires life insurance and nonlife insurance companies to capitalize and amortize specified policy acquisition expenses based on a proxy of the net premiums received on certain specified insurance contracts (often referred to as the "DAC tax"). DAC amounts are intended to serve as a surrogate for an insurance company's actual cost of acquiring insurance contracts. The amortization is computed on a straight-line basis over 120 months, beginning with the first month in the second half of the tax year that the premiums are received.[49] The current specified insurance contract categories and their corresponding percentages are as follows: (i) 1.75% for annuity contracts, (ii) 2.05% for group life insurance contracts and (iii) 7.7% for other life and certain accident and health contracts.[50]

Both indemnity and assumption reinsurance transactions are subject to §848 to the extent net consideration is transferred between the ceding company (target) and the reinsurer (acquirer). Under §848, a company's net premiums subject to DAC capitalization are determined by taking into account the premiums and other consideration incurred for reinsurance.[51] If the target company has net positive consideration from the reinsurance transaction, that amount is added to the amount of the premium and consideration from contracts other than the reinsurance agreement. If the target company has net negative consideration from the reinsurance transaction, that amount is subtracted from its gross premiums in determining net premiums subject to DAC capitalization.[52]

The amount required to be capitalized under §848 cannot exceed the company's general deductions as calculated under §848(c)(1). This is referred to as the "general deductions limitation." In order to ensure consistency between the ceding company (target) and the reinsurer (acquirer), the applicable Treasury Regulations deny a party to a reinsurance transaction any credit for DAC premium transferred unless the other party actually capitalizes such transferred premium.[53] In order to avoid losing DAC credit because the other party to the reinsurance transaction has a small amount of general deductions, a joint election is available. Under the joint election, the company is required to capitalize specified policy acquisition expenses with respect to the reinsurance transaction without regard to the general deductions limitation.[54]

A U.S. company does not get credit for DAC premium transferred to a non-U.S. company.[55] In addition, if a U.S. company that reinsures to a non-U.S. company has negative net consideration, it reduces (but not below zero) any unamortized balances of a prior-year capitalization attributable to reinsurance agreements with foreign companies, and to the extent remaining it carries over to reduce future net positive consideration attributable to reinsurance transactions with non-U.S. companies.[56] A foreign net negative capitalization amount may not be used to offset any costs subject to capitalization attributable to domestic reinsurance business.[57]

If a U.S. company that reinsures to a non-U.S. company has positive net consideration, it is offset by any carryover from prior years of net negative consideration attributable to reinsurance transactions with non-U.S. companies. To the extent remaining, such consideration is treated as additional specified policy

[49] §848(a)(2).

[50] §848(c)(1)(A)–§848(c)(1)(C).

[51] §848(d)(1).

[52] Reg. §1.848-2(a), §1.848-2(b).

[53] Reg. §1.848-2(g).

[54] Reg. §1.848-2(g)(8).

[55] §848(d)(1)(A).

[56] Reg. §1.848-2(h)(6).

[57] Reg. §1.848-2(h)(6)(ii).

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acquisition costs subject to capitalization and amortization.[58] Note that an election must be made under Reg. §1.848-2(h)(3) to separately determine the amounts required to be capitalized for the taxable year with respect to reinsurance agreements among parties that are not subject to U.S. tax. If this election is made, an insurance company separately determines a net foreign capitalization amount for the taxable year for all reinsurance agreements to which Reg. §1.848-2(h) applies.

In the context of an acquisition, the target's DAC balance represents a tax asset that can be valuable because it results in future amortization deductions. To the extent that there is a §382 change of control of the target (either as a result of the acquisition or when combined with the other transactions), and to the extent the target is in a net unrealized built-in loss position, there is a question as to whether the DAC balance is properly treated as a RBIL and therefore subject to the §382 limitation discussed above. To the extent the DAC balance is treated as an RBIL, potential buyers should ensure the NOL modeling takes this into account as it will likely affect the present value of the DAC balance (and any NOLs).

The Consolidated Insurance Company: Life vs. Nonlife

Historically, the distinction between life and nonlife insurance companies has had a significant impact on the U.S. consolidated return treatment of such affiliated groups. Congress was concerned that historically profitable life insurance companies would acquire nonlife companies with tax losses in order to offset the life insurance company income. Thus, the Revenue Act of 1928 prevented life insurance companies from filing consolidated returns with nonlife companies.[59] Congress changed its position in 1976 when it passed the Tax Reform Act of 1976 (the ''TRA''), which enabled companies to file consolidated returns with nonlife companies beginning in 1981.[60] Although Congress changed its position in the TRA to allow life and nonlife companies to file consolidated returns, the privilege does not come without restrictions, as discussed below.[61]

A life insurance company cannot join in a U.S. consolidated return with corporations that are not life insurance companies unless such life insurance company has been a member of the group filing the consolidated return for the preceding five taxable years.[62] The affiliation test of §1504 is applied without regard to the general exclusion for life insurance companies provided for by §1504(b)(2). In the case of nonlife corporations, their losses cannot be taken into account in determining the taxable income of the life members until after the nonlife members have been members of the same affiliated group for five consecutive years.[63] These two tests are often referred to as the ''five-year requirements.'' The complexity these provisions add has been repeatedly noted by companies, practitioners, trade organizations, and even the Joint Committee on Taxation:

> The treatment of affiliated groups of corporations that include both life insurance companies and other types of companies is more complicated that other types of affiliated groups that wish to file consolidated returns. The two five-year rules require substantial additional record-keeping and calculations by taxpayers, as well as creating complexity in structuring business transactions.[64]

In order to file a life-nonlife consolidated return, an election under §1504(c)(2) must be made to treat domestic life insurance companies as includible corporations. The election must be made by the common parent of the affiliated group. Once made, the election is binding on future years, and may only be terminated by obtaining the Commissioner's consent.[65]

In order to determine whether the five-year requirements of §1503(c) and §1504(c) are satisfied, the Treasury Regulations provide rules for determining whether a corporation is ''eligible'' or ''ineligible.'' If a corporation is not ''eligible,'' it is ''ineligible.'' As discussed in more detail below, the tests to determine whether a corporation is ''eligible'' can be complex in application. The consequences of a life insurance company being ''ineligible'' are that it is not an includible corporation and therefore cannot consolidate with a nonlife company.[66] On the other hand, if a nonlife insurance company is ''ineligible,'' it is still treated as an ''includible'' corporation, however its

[58] Reg. §1.848-2(h)(4).

[59] Pub. L. No. 70-562, §141, 791 Stat. 831.

[60] Pub. L. No. 94-455, §1507, 90 Stat. 1520, 1739.

[61] *Id.*

[62] §1504(c)(2)(A).

[63] §1503(c)(2).

[64] *Study of the Overall State of the Federal Tax System and Recommendations for Simplification Pursuant to Section 8022(3)(B) of the Internal Revenue Code of 1986, JCS-3-01 at 382.*

[65] Reg. §1.1502-47(e)(3).

[66] Reg. §1.1502-47(d)(13).

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NOLs cannot be used to offset life insurance member profits.[67]

Under Reg. §1.1502-47(d)(12), a corporation must meet four requirements throughout each day of the base period of the tested taxable year to be considered an ''eligible'' corporation. The base period consists of the five taxable years of the group's common parent that precede the tested taxable year.[68] The four requirements that must be satisfied for each day of the base period are (1) the corporation must have been in existence and a member of the group as defined in §1504(a) without regard to §1504(b)(2); (2) the corporation must have engaged in the active conduct of a trade or business; (3) the corporation must not have undergone a change in ''character'' defined as a change in the Code section under which the corporation is taxed; and (4) the corporation must not have undergone a ''disproportionate asset acquisition.''[69]

Even if the limitations described above are satisfied, only a portion of a nonlife insurance company's losses can offset the income of the life insurance members in the consolidated life-nonlife group. Under §1503(c)(1), any portion of the nonlife insurance subgroup loss that is not absorbed as a carryback is applied against current year income of the life insurance company members to the extent of the lesser of (i) 35% of the nonlife insurance members' unabsorbed loss or (ii) 35% of the life insurance company members' income. The unused portion of the nonlife insurance subgroup loss is available as a carryover, subject to the same limitations.[70] Further, and more generally, for purposes of computing taxable income, Reg. §1.1502-47(a) provides that the consolidated taxable income of a life-nonlife group is determined by using a subgroup method. The life-nonlife consolidated group is separated into two separate subgroups consisting of life members and nonlife members.[71] Special rules in Reg. §1.1502-47 set forth the computation of consolidated taxable income.

With respect to two or more life insurance companies, §1504(c)(1) permits such life insurance companies to constitute an affiliated group of includible corporations assuming the requisite 80% ownership tests are satisfied. Such affiliated life insurance companies can elect to file a consolidated return as a group without regard to whether any related nonlife insurance companies file consolidated returns or separate returns.

In considering the potential application of the complex set of rules applicable when life insurance companies may be involved, it is important to keep in mind that the definition of a life insurance company refers to the activities of the company for the entire taxable year, and the determination of whether a company is a life insurance company or nonlife insurance company is tested on an annual basis using the qualification fraction.[72] Thus, if short taxable years are involved a result of an acquisition or disposition, it is possible for an insurance company to be a nonlife insurance company for part of the year, and a life insurance company for another part of the year.[73] This can obviously have implications concerning the ability of insurance company targets to join in the filing of life-nonlife or life-life consolidated returns. Moreover, in connection with the acquisition of a life company that is part of a different consolidated group, or is joining a consolidated group, the company may be required to file two returns for a single tax year.

The consolidated return Treasury Regulations provide specific rules for intercompany insurance transactions. Under Reg. §1.1502-13(e)(2)(ii)(A), intercompany insurance transactions are generally taken into account on a separate entity basis. For example, a brother-sister captive insurance arrangement would be treated in the same manner as if unaffiliated companies entered into the transaction — i.e., taken into account by both parties as if they were separate entities. On the other hand, under Reg. §1.1502-13(e)(2)(ii)(B)(1), items arising from an intercompany reinsurance transaction are taken into account under the matching rule and the acceleration rule. Thus, amounts transferred as reinsurance premiums, expense allowances and other similar items are taken into account under the matching rule and acceleration rule. Dividends received from other members of an affiliated group filing a U.S. consolidated return are generally excluded from the recipient's income.[74] If a life insurance company is not included in a life-nonlife consolidated return because it is ineligible (i.e., the five-year waiting period has not passed), any such dividend paid by the life insurance company member is not eligible for the exclusions contained in the consolidated return Treasury Regulations.[75] However, the common parent of the affiliated group can elect to have any such dividend treated as a qualifying dividend, and therefore receive a 100% deduction.[76] A dividend by such life member will not be treated as a qualifying dividend if such dividend is out of earnings and profits for a taxable year for which an

[67] *Id.*

[68] Reg. §1.1502-47(d)(12)(ii).

[69] *Id.*

[70] §1503(c)(1).

[71] Reg. §1.1502-47(a)(2)(i).

[72] *See* §816(a); Reg. §1.801-3(b).

[73] *See* Rev. Rul. 77-210, 1977-1 C.B. 267.

[74] Reg. §1.1502-13(f)(2).

[75] Reg. §1.1502-13(f).

[76] §243(b)(3).

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election under this paragraph is not effective.[77] Thus, any dividends paid out of an ineligible life insurance company's pre-acquisition earnings will only be subject to the 80% deduction.

Shareholder Surplus Accounts and Policyholder Surplus Accounts

The Tax Reform Act of 1984 changed the taxation of life insurance companies by eliminating the phase III deferral of income under the Life Insurance Company Act of 1959 for income earned after the 1983 year.[78] However, there is a requirement that life insurance companies maintain their legacy (i.e., existing) shareholder surplus accounts (''SSA'') and policyholder surplus accounts (''PSA''), reflecting deferred income from prior years.[79] Life insurance companies must recognize deferred income from PSAs when distributions are made to shareholders (the so-called ''phase III tax''). §815. This tax is in addition to any tax otherwise imposed on a life insurance company.

Section 815(b) provides that direct or indirect distributions to life insurance company shareholders are treated as made (i) first out of the SSA, (ii) then out of the PSA, and (iii) then out of any other accounts. For the 2005 and 2006 tax years, the tax imposed on a life insurance company for distributions made to its policyholders from a PSA was temporarily suspended.[80] That is, such life insurance companies could make distributions to their shareholders from a PSA without incurring any tax (the amount of any distribution was treated as zero).[81] As a result of the temporary suspension of tax imposed with respect to distributions made from PSAs, one would expect that existing PSAs have been purged and thus the potential phase III tax eliminated. However, this is not necessarily the case for all companies, so the status of any PSAs should always be reviewed as part of the due diligence process.

Section 845 and Significant Tax Avoidance

The IRS has signaled its willingness in recent years to apply §845 to recharacterize reinsurance transactions and thereby alter the tax consequences. As a result, both affiliate and external reinsurance transactions may be subject to challenge by the IRS if the tax benefits are significant.[82]

Section 845(a) allows the Secretary of the Treasury to make adjustments to a reinsurance or retrocession contract between related parties (including arrangements serving as a conduit between related parties) in the case of tax avoidance or evasion. In that case, the Secretary may allocate items between or among the parties, recharacterize the items, or make any other adjustments the Secretary deems necessary to reflect the proper amount, source or character of the taxable income of the parties.

Section 845(b) allows the Secretary of the Treasury to make adjustments to a reinsurance or retrocession contract between related or unrelated parties if the contract has ''significant'' tax avoidance effect to one or both of the parties. The tax effect is significant ''if the transaction is designed so that the tax benefits enjoyed by one or both parties to the contract are disproportionate to the risk transferred between the parties.''[83] This test evaluates the economic substance of the contract using seven factors described in the legislative history, and two additional factors described by the Tax Court in *Trans City Life*.[84]

No one factor is exclusive nor determinative of the economic substance of the contract.[85] The factors are: (1) the duration or age of the business reinsured; (2) the character of the business reinsured; (3) the structure for determining the duration of the reinsurance agreement between the parties; (4) the parties' right to terminate the reinsurance agreement and the consequences of a termination; (5) the relative tax positions of the parties; and (6) the general financial situations of the parties.[86] The Tax Court factors added are (7) risk transferred versus tax benefits derived, and (8) state determinations.[87]

Given the broad discretion the IRS is afforded to recharacterize or even disregard certain reinsurance transactions, reinsurance agreements should always be carefully drafted bearing in mind the possibility of a future challenge.

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[77] §243(b)(3)(B).

[78] Pub. L. No. 98-369, §201–§331, 98 Stat. 494, 719–777.

[79] §815(c)(1), §815(d)(1).

[80] §815(g).

[81] §815(g)(1).

[82] *See* FAA 20092101F(response to request for advice concerning §845(b); Lee A. Sheppard, *New Analysis: IRS Defends Reinsurance Ruling* (June 1, 2009) (elec. cit. 2009 TNT 102-3); Sam Young, *IRS Not Backing Down on Reinsurance Antiabuse Statute, Official Says* (June 1, 2009) (elec. cit. 2009 TNT 102-7).

[83] *Trans City Life Ins. Co. v. Commissioner*, 106 T.C. 274, 303 (1996) (*quoting* H.R. Conf. Rep. No. 861, 98th Cong., 2d. Sess. 1063 (1984), 1984-3 C.B. (Vol. 2) 1,317).

[84] *Trans City Life*, 106 T.C. at 303.

[85] *Id.*

[86] 1984-3 C.B. (Vol. 2) at 317-318.

[87] *Trans City Life*, 106 T.C. at 308-10.

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Recognizing the Unique Issues Posed by Mutual Companies

While an extensive discussion of the application of specialized tax provisions to mutual insurance company transactions is beyond the scope of this article, an identification of the provisions more commonly encountered may be useful.

In order to be acquired by a stock company, a mutual insurance company must undergo a demutualization. In a demutualization, a mutual insurance company, which is owned by policyholders, becomes a stock company, which is owned by stockholders. In the demutualization, the policyholder receives either cash or stock in exchange for the policy surrendered therefor. Cash received is generally taxed as capital gain, and whether such gain is short-term or long-term depends on the holding period during which the policyholder held the policy. If common stock is received, and the transaction otherwise meets the requirements of a reorganization under §368(a)(1)(E), policyholders should not have taxable gain upon the receipt of such stock. The policyholder generally receives stock with a zero basis (at least under the IRS's view) such that when the stock is subsequently sold the stockholder recognizes capital gain, if any, on the sale.[88] Whether such gain is short-term or long-term depends on the holding period during which the policyholder held the policy exchanged therefor, and the period during which the stockholder held the stock that was subsequently sold.

A mutual merger is simply a merger between two mutual insurance companies (for example, a mutual insurer domiciled in one state merging with and into a mutual insurer domiciled in another state). An alternative to a mutual merger is a mutual affiliation. A mutual affiliation is a contractually based, cooperative relationship between two mutual insurance companies. Each insurance company retains its separate corporate existence, policyholder and membership base, but modifies certain aspects of its operations with the intent to benefit from the operations of its affiliate. Typically, a mutual affiliation would result in one mutual insurer ''controlling'' the other for purposes of regulatory law.

[88] *See* Rev. Rul. 71-233, 1971-1 C.B. 113. In 2008, the Court of Federal Claims rejected the IRS's ''zero basis'' position. *Fisher v. United States*, 82 Fed. Cl. 780, 795–97 (2008), *aff'd*, 333 F. App'x 572 (Fed. Cir. 2009).

CHALLENGE 4: IDENTIFYING AND ANALYZING CROSS-BORDER ADJUSTMENTS

''For every complex problem there is an answer that is clear, simple, and wrong.''

— H. L. Mencken

Federal Excise Tax for Foreign Insurer and Foreign Reinsurer

Section 4371 imposes a federal excise tax (''FET'') on each policy of insurance, indemnity bond, annuity contract, or policy of reinsurance issued by any foreign insurer or reinsurer that insures a United States risk.

- Section 4371(1) imposes an excise tax at the rate of four cents on each dollar of premium paid for direct insurance of U.S. property and casualty risks.
- Section 4371(2) imposes an excise tax at the rate of one cent on each dollar of premium paid for a life or accident and health policy or annuity with respect to a U.S. citizen or resident.
- Section 4371(3) imposes an excise tax at the rate of one cent on each dollar of premium paid for reinsurance of U.S. risks.
- While the Service generally holds the party that is making the premium payments liable for the FET, the liability is technically joint and several. Under §4374, the FET may be imposed on the insured, policyholder, insurance company or broker obtaining the insurance.

Exemptions from the FET under §4371 may be established based upon tax treaties between the United States and a treaty country. Rev. Proc. 2003-78[89] provides instructions for establishing an exemption from the FET and entering into a closing agreement with the IRS.

When an insured pays a premium to a foreign insurance company for either direct or indirect insurance or reinsurance, and such premium payment is subject to tax, and the foreign insurer subsequently reinsures all or part of the risk with another taxable foreign insurance company, the IRS contends that each reinsurance transaction subsequent to the initial taxable premium payment is subject to the 1% excise tax. Under Rev. Rul. 2008-15,[90] the IRS explains its position that the FET potentially applies to all legs of sub-

[89] 2003-45 I.R.B. 1029.

[90] 2008-12 I.R.B. 633.

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sequent reinsurance transactions. Thus, under the IRS's position, the FET can apply to the same risks more than once: that is, once to the initial insurance of U.S. risks by a foreign insurer, and then again each time the risks are subsequently reinsured or retroceded with another foreign reinsurer (referred to as a ''cascading excise tax'').

Commentators have disagreed with the IRS's cascading excise tax theory, both on legal and practical grounds. First, from a legal standpoint, commentators have asserted that nowhere is the extraterritorial cascade theory supported by the Congressional intent or legislative history of the FET (the FET was originally enacted as a stamp tax on domestic insurers). What is more, the Tax Court's rationale rejecting the cascade theory in *SDI Netherlands B.V. v. Commissioner*,[91] would likely apply to the cascading excise tax in Rev. Rul. 2008-15. Second, from an administrative standpoint, commentators have argued that (1) collecting the tax from non-U.S. companies will be difficult, as it is unclear how the IRS would know if there is a subsequent reinsurance transaction between foreign insurance companies, and (2) the burden of collection will fall on domestic companies that do not have the requisite information to administer the tax.

The first legal challenge to the IRS's ''cascading'' application of the FET to premiums paid by one foreign insurer or reinsurer to another foreign reinsurer in connection with insurance policies covering U.S. risks was *Validus Reinsurance, Ltd. v. United States*.[92]

Validus Reinsurance, Ltd. (Validus) is a foreign corporation that both purchases and sells reinsurance. The contracts at issue in *Validus* were reinsurance contracts that Validus had purchased to protect itself against losses it might incur on reinsurance contracts it had sold to U.S. insurers with respect to certain U.S. risks. Despite the fact that neither Validus nor its retrocessionaires conducted business in the United States during the years in question, the IRS determined that the FET was applicable to these wholly foreign retrocession transactions. Validus paid the assessed tax, filed claims for refund and sued in U.S. District Court in the District of Columbia.

On cross motions for summary judgment, the district court found that the FET applied to *reinsurance* contracts that are issued by foreign reinsurers and cover U.S. risks based on a plain reading of §4371. However, because the premiums at issue were paid for *retrocession* contracts, which are not encompassed by the provisions of §4371, the court rejected the IRS's argument that retrocessions should be included under the excise tax statute to effect Congress's intent of placing U.S. and foreign reinsurers on equal ground (because foreign reinsurers are not subject to income tax). In reaching its decision, the district court rejected the Service's argument that, if Congress had intended to have an exception to the FET for retrocessions, the statute would have explicitly provided for the exception. The IRS appealed the decision.

On May 26, 2015, the Court of Appeals for the District of Columbia affirmed the district court's decision but on narrower grounds.[93] The D.C. Circuit noted that a statute has no extraterritorial application unless there is clear Congressional intent to give the statute that effect. In its reasoning, the D.C. Circuit concluded that §4371 was ambiguous with respect to its application of wholly foreign retrocessions and ''[n]either the text, context, purpose, nor legislative history provide a clear indication of congressional intent to rebut the presumption against such expansive extraterritorial application.'' The court rejected the IRS's argument that Rev. Rul. 2008-15 should be given deference because there was no evidence that the IRS had considered the presumption against extraterritoriality when it promulgated the revenue ruling. One could read the decision as going further than the district court to invalidate the application of the FET to all wholly foreign reinsurance or retrocession contracts.

Given that the IRS's position was rejected in the first phase of the litigation, many companies took steps to protect the statute of limitations and filed protective claims for the refund of excise tax paid in connection with foreign-to-foreign reinsurance transactions. Due diligence should include a review of whether such claims have been filed for prior years, and the statute of limitations on refund for all relevant taxable years should be reviewed in order to preserve all possible claims.

Foreign Account Tax Compliance Act

Depending on the types of contracts issued, foreign insurance companies may be subject to increased reporting requirements under the Foreign Account Tax Compliance Act (''FATCA'').[94] Section 501(a) of the Act added a new chapter 4 (§1471–§1474) to Subtitle A of the Code. Chapter 4 expands the information reporting requirements imposed on foreign financial institutions with respect to certain United States accounts. Chapter 4 also imposes withholding, documentation and reporting requirements with respect to payments made to certain foreign entities.

[91] 107 T.C. 161 (1996).

[92] 19 F. Supp. 3d 225 (2014).

[93] 786 F.3d 1039 (D.C. Cir. 2015).

[94] Enacted as part of the Hiring Incentives to Restore Employment Act of 2010, Pub. L. No. 111-147, §501–§541, 124 Stat. 97-117 (H.R. 2847) (the ''Act''), on March 18, 2010.

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Although the statute does not specifically address insurance companies, it is intended that certain insurance companies be subject to FATCA. The Secretary has authority to ''prescribe special rules addressing circumstances in which certain categories of companies, such as insurance companies, are financial institutions or the circumstances in which certain contracts or policies, for example annuity contracts or cash value life insurance contracts, are financial accounts or United States accounts.''[95]

On January 17, 2013, Treasury and the IRS released final regulations implementing the Foreign Account Tax Compliance Act provisions. The proposed regulations[96] that preceded the final regulations included several provisions specific to insurance companies. Many of these insurance-specific provisions were of concern to the insurance industry. It is also the case that certain of the general provisions were of concern to other stakeholders. The proposed regulations provoked comment from hundreds of interested parties and stakeholders. With respect to the insurance industry, comments on the proposed regulations were submitted by insurance companies, industry associations, and the Insurance Companies Committee of the American Bar Association Section of Taxation.[97] An in-depth discussion of the consideration or application of FATCA in connection with insurance company transactions is beyond the scope of this article, but the previously cited comment letters will likely help to illuminate the potential concerns.

Compliance with FATCA will be an important consideration in connection with transactions having cross-border features and involving foreign-issued insurance contracts. Information reporting under FATCA begins with certain data collected in 2013. The withholding provisions of FATCA apply to withholdable payments made on or after January 1, 2014. Withholding on gross proceeds is delayed an additional year to 2015. Reporting obligations are implemented on a rolling basis based on type of institution, and began on March 31, 2015.[98]

[95] Staff of the Joint Comm. on Taxation, 111th Cong., 1st Sess., *Technical Explanation of the Revenue Provisions Contained in Senate Amendment 3310*, the ''Act,'' at 44 (2010).

[96] REG-121647-10.

[97] *See ABA Section of Taxation Comments on Proposed Regulations Under the Foreign Account Tax Compliance Act Offset Provisions of the HIRE Act, P.L. 111-147 Relating to Insurance Issues* (June 15, 2012).

[98] More information is available on the Internal Revenue Service website at http://www.irs.gov/Businesses/Corporations/Summary-of-FATCA-Timelines.

CHALLENGE 5: CAPTIVE INSURANCE CONSIDERATIONS

''Risk comes from not knowing what you're doing.''

— Warren Buffet

Captive insurance entities are an increasingly popular tool for risk management purposes within a corporate group. They are popular with all types of companies, from manufacturers to tech companies, and serve a variety of purposes. While the origins of today's captive industry lie offshore, on-shore captives are increasingly popular, and the states have rushed to adopt favorable captive legislation in order to capture the revenue generated by a robust captive community. Not everyone widely embraces the captive concept. Regulators are concerned that risk is not adequately being reserved for, and at the same time the IRS is concerned that certain captive structures are more focused on tax avoidance than risk management. Thus, care should be taken to perform appropriate due diligence when an acquisition includes the acquisition of a captive insurance company.

Overview of the Proper Tax Treatment of Captive Arrangements

Cases analyzing captive insurance arrangements have distilled the concept of ''insurance'' for federal income tax purposes to three elements, applied consistently with principles of federal income taxation: (1) the risk involved must be an insurance risk; (2) the risk must be both shifted and distributed; and (3) the arrangement must constitute insurance in the commonly accepted sense.[99]

In the parent/captive context, the issue is generally a combination of whether the risk actually shifted and whether the risk was distributed. The IRS and Treasury have provided ''safe harbor'' guidance on that point in a number of revenue rulings. Rev. Rul. 2005-40 explains that in order for an arrangement to qualify as insurance, both risk shifting and risk distribution must be present. The risk distribution requirement is not satisfied if the issuer of an ''insurance'' contract enters into such a contract with only one policyholder. Further guidance is found in Rev. Rul. 2002-89, which sets forth circumstances under which arrangements between a domestic parent corporation and its wholly owned subsidiary constitute insurance, and in Rev. Rul. 2002-90, which sets forth circumstances under which payments for professional liabil-

[99] *See e.g., AMERCO, Inc. v. Commissioner*, 979 F.2d 162, 164–165 (9th Cir. 1992), *aff'g* 96 T.C. 18 (1981).

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ity coverage by a number of operating subsidiaries to an insurance subsidiary of a common parent constitute insurance. Finally, Rev. Rul. 2002-91 sets forth circumstances under which amounts paid to a group captive of unrelated insureds are deductible as insurance premiums, and circumstances in which the group captive qualifies as an insurance company.

In 2014, the U.S. Tax Court issued two opinions that significantly affect the IRS's longstanding position that an arrangement cannot qualify as insurance if the risks are concentrated in a small number of insureds.[100] These cases addressed two issues: whether the presence of a guarantee of the captive insurer by its parent *per se* vitiates risk transfer, and whether a high concentration of risks in a single insured violates the risk distribution criteria. Both cases establish that parental guarantees do not per se vitiate risk shifting in captive arrangements because the issue requires a facts and circumstances analysis. With regard to risk distribution, both cases establish that risk distribution should be viewed from an insurer's perspective and depends on the presence of a sufficient number of individual risks and not on the number of insureds.

Despite these taxpayer victories, there are still captive insurance arrangements that the IRS perceives as abusive. In that connection, the IRS has placed Captive Insurance on the ''Dirty Dozen'' List of Tax Scams for the 2015 Filing Season.[101] The IRS has identified an abusive transaction with certain small or ''micro'' captive insurance companies wherein an unscrupulous promoter assists with creating and ''selling'' to the entities often times poorly drafted ''insurance'' binders and policies to cover ordinary business risks or esoteric, implausible risks for exorbitant ''premiums.''[102] The IRS explained that abusive tax structures involving captive insurance companies are generally set up to take advantage of the fact that the insured can claim deductions for premiums paid on insurance policies with the captive insurance company. In turn, the captive insurance company can elect under §831(b) to be taxed only on investment income, provided that the captive insurance company's net written premiums (or direct written premiums, if larger) do not exceed $1.2 million per year. This effectively excludes $1.2 million from taxable income annually.

The IRS's commitment to identifying these types of abusive arrangements is evident in the public disclosure last Fall of Artex Risk Solutions, the Bermuda-based captive management subsidiary of insurance broker Arthur J. Gallagher & Co., that it was the subject of an IRS investigation related to the formation of captives under §831(b). It is unclear how many captive managers are being approached by the IRS, but in light of the fact that the IRS has placed these types of arrangements on the dirty dozen list, it is safe to assume that the IRS is devoting significant resources.

Captive Insurance Entities Within Insurance Company Structures

Captive insurance entities also are important for risk diversification and capital management within an insurance company affiliated group. Captives provide a way for insurance companies to increase their underwriting capacities, as well as effectively manage risk and deploy capital efficiently. The reserve requirements imposed under state regulatory law are generally conservative, and the regulatory environments in certain foreign jurisdictions provide opportunities to effectively manage capital as well as risk by freeing up significant capital as a result of lower reserve requirements. As a result, foreign captives or affiliate reinsurers provide an attractive alternative for U.S. companies to utilize reinsurance in order to free up surplus.

The benefits provided by the lower reserve requirements are offset by the burden of the FET, discussed above. The foreign captive or affiliate may avoid the FET, however, if certain statutory exemptions provided under §4373 and §953 apply. Section 4373(1) provides an exemption from premiums subject to U.S. federal income tax (through income effectively connected with the conduct of a trade or business within the United States) and §953(c) is applicable to a ''controlled foreign corporation'' (a ''CFC'') which is a captive company.

Section 953(c)(3)(C) allows a CFC to elect to treat income as effectively connected. Section 953(d) permits an insurance company CFC to elect to be treated as a domestic corporation. While the latter two elections will help a foreign affiliate avoid FET, other tax issues should be taken into consideration. For example, if a company elects under §953(d) to be treated as a domestic corporation, it must treat any loss as a dual consolidated loss under §1503(d), thereby preventing the foreign company from using its losses to reduce the taxable income of any other member of its affiliated group for any tax year. Thus, a thorough analysis of the foreign company's structure and any elections it may have made is essential during the due diligence period.

CFC Insurance Rule and Related Party Insurance Income

If a foreign corporation is a CFC for an uninterrupted period of 30 days or more during the tax year,

[100] *Rent-A-Center, Inc. v. Commissioner*, 142 T.C. 1 (2014), *Securitas Holdings, Inc. v. Commissioner*, T.C. Memo 2014-225.

[101] IR-2015-19, *Abusive Tax Shelters Again on the IRS ''Dirty Dozen'' List of Tax Scams for the 2015 Filing Season* (Feb. 3, 2015).

[102] *See id.*

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§951(a)(1) imposes current U.S. tax on a U.S. shareholder's "pro rata share" of various types of income of the CFC. As noted above, a CFC is a foreign corporation where more than 50% of the vote or the value is owned by U.S. shareholders. A "U.S. shareholder" is any person owning at least 10% of the total combined voting power of all classes of stock of the foreign corporation. Special rules apply for purposes of taking into account insurance income. A foreign corporation is an "insurance CFC" if its 10% U.S. shareholders own more than 25% of the vote or value of the insurance company.[103] In addition, more than 75% of the premiums and other consideration that the foreign corporation receives on account of all risks must be "insurance income" as defined under §953.[104] Moreover, for purposes of allocating insurance income derived from the insuring of related parties (discussed below), all U.S. shareholders (not just 10% or more shareholders) are included for purposes of the 25% test.[105]

Under §953, related party insurance income ("RPII") is defined as "any insurance income attributable to a policy of insurance or reinsurance with respect to which the primary insured is a U.S. shareholder in a foreign corporation or related person to such a shareholder." There are two de minimis exceptions to the RPII rules: (i) if RPII in a particular year is less than 20% of the company's total insurance income then RPII rules will not apply for that year; and (ii) if all RPII income is generated by less than 20% of the company's shareholders the RPII rules will not apply.[106]

CHALLENGE 6: PROPERLY VALUING LIFE INSURANCE, ENDOWMENT AND ANNUITY CONTRACTS

"Someone told me that each equation I included in the book would halve the sales."

Brief History of Time, Stephen W. Hawking

In the context of acquisitions involving life insurance and annuities, a critical aspect of valuing, negotiating and pricing the deal involves an assessment of whether the insurance products meet, and have at all times met, the various qualification tests set forth in the Code. The tax status of the contracts affects the characterization of the company as a life insurance company or a nonlife insurance company, as well as dictating the tax treatment of the contracts to the insurance company, contract holder and beneficiaries in connection with withdrawals, payments or distributions from the contract.

Typically, actuaries and system analysts will be involved in the early phases of the diligence process because product qualification often turns on actuarial assumptions, and in some cases on the design of the technical systems intended to monitor product compliance and failures. Although the IRS has promulgated procedures under which a company may seek to remediate failed contracts, diligence efforts should nonetheless include review of all waivers previously received from the IRS, as well as any closing agreements entered into in connection with contract failures. Even though such failures are relatively common, and, in the case of waivers, relatively harmless, failed contracts can be a sign of poor administrative systems or weak internal controls. The execution of closing agreement procedures incorporate a "toll charge" designed to compensate the government for the tax that would have been collected from the policyholders, who are third party beneficiaries to the closing agreements. This toll charge is not a deductible expense, nor is it refundable, subject to credit or offset, or otherwise recoverable from the IRS.

In light of the above, the valuation of an insurance business for merger and acquisition purposes includes valuation analyses specific to the types of insurance products involved. The initial review of the insurance products to be acquired is not only important for valuation of the business, it can be a useful tool for assessing potential tax issues. That way, the acquirer can assess not only whether these issues may affect the terms to be negotiated, but also whether there may be additional consequences in connection with the business acquired in the post-transaction phase.

The Code contains specific provisions intended by Congress to prevent overly investment-oriented contracts from qualifying as life insurance products for tax purposes. The provisions were enacted to prevent the continued proliferation of contracts styled as "life insurance" but serving as mere deferral devices for investment income. In general, for contracts issued after December 31, 1984, §7702 provides a definition of the term "life insurance" for all purposes of the Code. First a life insurance or endowment contract must be treated as such under "applicable law," which has been interpreted to mean applicable federal, state or foreign law.[107] In addition, the contract must also either:

- Meet the cash value accumulation test of §7702(b), *or*

[103] §957(b).
[104] *Id.*
[105] §953(c)(1).
[106] *See* Prop. Reg. §1.953-7(a), §1.953-7(b).

[107] *Wickum v. Commissioner,* T.C. Memo 1998-270.

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- Satisfy the guideline premium requirements of §7702(c), *and*
- Fall within the cash value corridor test of §7702(d).

These guidelines work to ensure that the cash value accumulated by the premium does not exceed that of the future benefits. As mentioned above, a waiver may be obtained for contract failures under certain circumstances. The process for obtaining a waiver is described by Rev. Proc. 2008-42,[108] which permits the issuer of a life insurance contract to obtain a waiver under §7702(f)(8) or §101(f)(3)(H) for certain reasonable errors that caused the contracts to fail. If such a waiver is not available,[109] provides a separate more costly procedure by which an issuer of a life insurance contract may remedy the failure of one or more contracts to meet the definition of a life insurance contract under §7702(a) or to satisfy the requirements of §101(f). This process incorporates the closing agreement and toll charge provisions mentioned previously.

In certain instances, a life insurance contract that otherwise meets the requirements of §7702 may be treated as a modified endowment contract (a ''MEC''). MECs are generally taxed under the same rules that apply to other life insurance contracts, except with respect to the timing and the amount of U.S. federal income tax imposed on amounts received by the policyholder during the insured's lifetime.[110] For this reason, the inadvertent creation of a MEC is to be avoided at all costs. A contract is considered a MEC if it fails the seven-pay test of §7702A(b). A contract fails the seven-pay test if the accumulated amount paid under the contract at any time during the first seven contract years exceeds the sum of the net level premiums which would have been paid on or before such time if the contract provided for paid-up future benefits after the payment of seven level annual premiums.[111]

Correction procedures are also available to remedy contracts that are inadvertently rendered MECs. Rev. Proc. 2008-39[112] provides a procedure by which an issuer of a life insurance contract may remedy an inadvertent non-egregious failure to comply with the MEC rules under §7702A.

Life insurance companies offer a wide array of products based on separate accounts, including variable contracts. These products are subject to additional rules, including being subject to the ''investor control'' doctrine, as well as the diversification requirements under §817(h). The investor control doctrine was the subject of a recent Tax Court decision, which described the doctrine as follows:

> The ''investor control'' doctrine posits that, if a policyholder has sufficient ''incidents of ownership'' over the assets in a separate account underlying a variable life insurance or annuity policy, the policyholder rather than the insurance company will be considered the owner of those assets for Federal income tax purposes. The critical ''incident of ownership'' that emerges from these rulings is the power to decide what specific investments will be held in the account. As the Commissioner stated in Rev. Rul. 82-54, 1982-1 C.B. at 12, ''control over individual investment decisions must not be in the hands of the policyholders.'' Other ''incidents of ownership'' emerging from these rulings include the powers to vote securities in the separate account; to exercise other rights or options relative to these investments; to extract money from the account by withdrawal or otherwise; and to derive, in other ways, what the Supreme Court has termed ''effective benefit'' from the underlying assets. *Griffiths*, 308 U.S. at 358.[113]

The *Webber* case also resolved a long-standing disagreement between the Service and certain tax advisors as to the diversification rules under §817(h) were intended to displace the investor control doctrine:

> In sum, by enacting §817(h), Congress directed the Commissioner to promulgate standards for determining when investments in a segregated asset account, though actually selected by an insurance company, ''are made, in effect, at the direction of the investor.'' H.R. Conf. Rept. No. 98-861, above at 1055, 1984-3 C.B. at 309. It would be wholly contrary to Congress' purpose to conclude that the enactment of §817(h) disabled the Commissioner from determining, under the ''investor control'' doctrine, that investments in a segregated asset account are made, in actual reality, at the direction of the investor. The Secretary clearly stated, when promulgating the new diversification standards, that the ''investor control'' doctrine would continue to apply, and the Commissioner's public and private rulings during the ensuing 30 years confirm his view that this

[108] 2008-29 I.R.B. 160.

[109] Rev. Proc. 2008-40, 2008-29 I.R.B. 151.

[110] §72(e).

[111] §7702A(b).

[112] 2008-29 I.R.B. 143.

[113] *Webber v. Commissioner*, 144 T.C. No. 17 (2015).

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doctrine remains vital. Congress has certainly evidenced no disagreement with that position. For all these reasons, we conclude that the enactment of §817(h) did not displace the bedrock ''investor control'' principles enunciated in Rev. Rul. 77-85.[114]

Variable contracts, as defined under §817(d), which are based on one or more segregated asset accounts, are not treated as an annuity, endowment, or life insurance contract for any calendar quarter period for which the investments of any such account are not ''adequately diversified.'' If a variable contract is not treated as an annuity, endowment, or life insurance contract, the income on the contract for any taxable year of the policyholder is treated as ordinary income received or accrued by the policyholder during that year.[115]

A private separate account provides the opportunity for additional customization of separate account products. Private separate accounts have at times been perceived as a way to provide the insured with more control over the assets of the separate account. In general, private separate accounts return some of the investment risk to the policyholder, and in that way are similar to non-insurance investment accounts. The Obama Administration's fiscal 2016 budget proposal includes proposed legislation that would require information reporting for private separate accounts of life insurance companies. This type of reporting could assist the IRS to better monitor accounts to insure that the ''investor control'' doctrine is not violated.

CHALLENGE 7: OFTEN-OVERLOOKED INSURANCE TAX CONSIDERATIONS

"If things seem under control, you are just not going fast enough."

— Mario Andretti

Special Rules Regarding §381 Transactions Involving Insurance Companies

Section 381 provides that a corporation that acquires the assets of another corporation in certain liquidations and reorganizations succeeds to, and takes into account the items described in §381(c) of, the distributor or transferor corporation. In addition, if the acquiring and transferor corporations are life insurance companies, §381(c)(22) provides that certain items must be taken into account to carry out the purposes of subchapter L. Such items include, among others, operating loss carryovers, net increases or net decreases in reserves, and capital loss carryovers.[116] Particular attention should be ascribed to the requirement that the acquiring corporation take into account the dollar balances in the SSA and PSA, which may in certain circumstances inadvertently result in a tax foot fault.[117]

Post-acquisition liquidations or mergers of a target insurance company may implicate the rules under §381 and should be analyzed to ensure that there are no adverse tax consequences associated with such post-acquisition restructuring.

Trust Issues

Reinsurance transactions often involve a trust arrangement whereby collateral is posted to the trust, which is used to support the obligations under the reinsurance arrangement. An issue that frequently arises is whether the trust qualifies as a grantor trust as determined under the grantor trust rules in §671– §677. Those rules generally provide that where a grantor is treated as the owner of all or any portion of the trust, the income of the trust is taken into account in computing taxable income of the grantor.[118] A grantor is the owner of a trust if, in relevant part, it (i) has a reversionary interest in either the corpus or income of the trust, (ii) has the power to control the disposition of the trust without the approval or consent of an adverse party, or (iii) has the power to revest title in the trust.[119]

Premium Taxes and Guaranty Fund Assessments

Domestic and foreign insurance companies are generally subject to a gross premium tax, which is imposed by a taxing authority at a certain rate on the insurance company's premiums, premium deposits or assessments. Premiums for reinsurance are normally not taxed by a taxing authority. In the context of an insurance related acquisition, the purchase or merger agreement should include premium taxes within the defined term for ''Taxes.''

A guaranty fund assessment is an assessment by the state on an insurance company, which is designed to make funds available to policyholder claims in the

[114] *Id.*

[115] Reg. §1.817-5(a)(1).

[116] Reg. §1.381(c)(22)-1(b)(1), §1.381(c)(22)-1(b)(6) and §1.381(c)(22)-1(b)(12).

[117] Reg. §1.381(c)(22)-1(b)(7).

[118] §671.

[119] §677.

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case where an insurance company becomes insolvent. Most states have laws requiring guaranty funds for both life insurance companies and property and casualty insurance companies. While not a tax per se, this concept is often included in the definition of ''Taxes'' in connection with insurance transactions.

CONCLUSION

''The large print giveth, but the small print taketh away.''

— Tom Waits

M&A generally involves weighing a number of factors and choosing among a number of structuring choices. The contours of a particular transaction may be shaped by business, legal and regulatory requirements, as well as by whether the lynchpin of the transaction structure is stock or assets. Often, the parties may have adverse interests when it comes to the preferred structure of the transaction, and this is particularly true with respect to insurance company transactions. Insurance company transactions present an added dimension of complexity in light of the interplay between subchapter C and subchapter L. Accurate and timely input as to the existence of these special rules, and their potential consequences, is vital to structuring a transaction to maximize value and avoid unintended tax and business consequences.

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