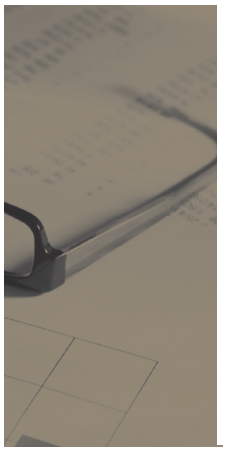
THE MYSTERY OF PLR 201006002

By Lori J. Jones and Julie V. Goosman



In PLR 201006002, the Internal Revenue Service (IRS) *appears* to apply section 351 and Rev. Rul. 94-45 to a variety of reinsurance transactions. At first glance, the PLR seems to break new ground by applying section 351 to the transfer of assets and insurance liabilities in an indemnity reinsurance transaction. However, as described below, a more in-depth review leads one to conclude that even though the PLR refers to a section 351 transfer "in the context of an indemnity coinsurance transaction," it is not referring to the transfer of assets underlying a transfer of insurance reserves. We will explain the reasons why the IRS should rule on the application of section 351 to the transfer of assets and reserves in an indemnity coinsurance transaction where the ceding company transfers more assets to the assuming company than it would in an arms-length transaction and, therefore, the ceding company actually receives or is deemed to receive stock in the exchange for the transferred assets including the value of insurance in force. We also will summarize other interesting rulings in the PLR.

BACKGROUND

Rev. Rul. 94-45, 1994-2 C.B. 39, concludes that the transfer of assets and statutory reserves by a life insurance company pursuant to an assumption reinsurance transaction to its wholly-owned subsidiary is a nonrecognition transaction under section 351. In the ruling, the life company transferred assets in excess of the assets that would have been transferred pursuant to an arms-length reinsurance transaction. No gain or loss was recognized on the transfer of the assets in exchange for stock under section 351 and the section 807 insurance reserves were treated as having been transferred in a step-in-the-shoes manner to the assuming company. In addition, the ruling holds that the unamortized section 848 policy acquisition expenses attributable to the transferred business are transferred to the transferee and continue to be amortized in the same manner as they would have been amortized by the transferor. Rev. Rul. 94-45 revoked Rev. Rul. 75-382, 1975-2 C.B. 121, which had concluded that while section 351 applied to avoid recognition of gain or loss on the transfer of all of the assets, the reinsurance was still taxable under subchapter L and Treas. Reg. § 1.817-4(d).

GENERAL CONCLUSIONS IN PLR 201006002

In PLR 201006002 (Nov. 6, 2009), there were numerous transactions occurring at or around the same time, including assumption reinsurance, indemnity coinsurance, co/modco reinsurance, the transfer of noninsurance liabilities and matching assets, and the transfer of obligations through a novation of existing reinsurance agreements. The focus of this article is on the indemnity coinsurance arrangements. The PLR first describes the assumption reinsurance transaction as a transfer of policies pursuant to an assumption reinsurance transaction where LifeCo5 assumes the statutory reserve liabilities of LifeCo3 and certain other related liabilities. A similar description applies to the transfer between LifeCo1 and LifeCo2. In contrast, the PLR describes the coinsurance portion of the transaction as follows:

> Also, in the context of an indemnity coinsurance transaction, LifeCo3 will transfer assets to LifeCo5 in excess of the premium that LifeCo3 would have paid in an arms-length transaction (net of any ceding commission that LifeCo3 would have received in such transaction) (the "Z Assets") and LifeCo5 will assume from LifeCo 3 miscellaneous liabilities which are not part of that transaction (the "Miscellaneous Liabilities").

The description of the coinsurance arrangement in the context of the LifeCo1/LifeCo2 proposed transactions is similar.

The PLR concludes in rulings (1) and (8) that section 351 applies to the Z assets and the VA Assets and X Receivables in the LifeCo1/LifeCo2 transactions. The $64,000 question is whether the section 351 transaction includes all of the assets transferred by the respective transferor in each indemnity coinsurance transaction. Apparently the answer is that when the PLR states that it applies section 351 to assets transferred "in the context of an indemnity coinsurance transaction" it means those "excess" (*i.e.,* surplus) assets over and above the assets transferred as premiums for reinsurance. Therefore, the PLR suggests that the IRS allowed the integrated transaction to be bifurcated into two pieces, one piece that was taxable under

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the reinsurance rules in Treas. Reg. § 1.817-4(d) (although no rulings specifically addressed the taxable part) and another piece involving the transfer of the surplus and noninsurance liabilities that was tax free under section 351 and presumably in exchange for stock of the transferee. This is arguably inconsistent with case law which concludes that section 351 is mandatory and bifurcation of an integrated transaction is not permitted.[1]

Besides the somewhat confusing description of the assets covered by section 351 (but clear lack of reference to statutory reserves), there are other indications in the ruling which suggest that section 351 was not applied to the transfer of the insurance reserves and related assets with respect to the indemnity coinsurance transaction. For example, representation (I) states that the tax bases of the transferred assets exceed liabilities for section 357(c) purposes. In determining the basis of the transferred assets, the taxpayer represented that only the unamortized section 848 expenses related to the assumption reinsurance transaction were taken into account.[2] If section 351 had applied to the business transferred by indemnity reinsurance, the unamortized section 848 expenses allocable to that business also should have been included. *See also* rep (DD). Ruling (4) applies the same rule to determine the basis of the "new" stock in the hands of the transferor. Also, as discussed below, rulings (14) and (15) suggest section 351 did not apply to assets transferred equal to the statutory reserves in the indemnity reinsurance transaction.

There is no good policy reason why section 351 should not apply to the entire indemnity coinsurance transaction. Even under the more restrictive conclusion in Rev. Rul. 75-382, section 351 applied to the transfer of all the assets. Furthermore, Rev. Rul. 94-45 supports the position that no gain should by recognized by the ceding company when the ceding commission is being paid in stock of the assuming company as part of a section 351 transaction. Because of the restrictive regulatory nature of assumption reinsurance transactions (*e.g.,* policyholder consents), many companies have used indemnity reinsurance in recent years to effect a complete transfer of a book of business. Obviously there is a wide variation in the manner in which indemnity reinsurance can be used—some arrangements having less qualities of permanence than others. The IRS should extend the application of section 351 to indemnity reinsurance transactions which involve the transfer of surplus to an assuming company or at least where the indemnity reinsurance transaction is of a permanent or semi-permanent nature.

The IRS has acknowledged this distinction with the issuance of Treas. Reg. § 1.197-2(g)(5)(iii)(A)(2). In most section 197 transactions, any section 197 intangibles created in the transaction are unable to be written off by the taxpayer until all section 197 intangibles acquired in the transaction are disposed of. The regulations make an exception to this general rule for a subsequent cession of insurance risks acquired in an assumption reinsurance transaction (or a section 338(h)(10) election deemed to be an assumption reinsurance transaction) that created a section 197 intangible. Because of the wide variation in the permanence of indemnity reinsurance transactions, to qualify for this exception, Treas. Reg. § 1.197-2(g)(5)(iii)(A)(2) requires that sufficient economic rights be transferred and the indemnity reinsurance transaction not contain a right to recover a significant portion of the future profits on the reinsured contracts through an experience refund or recapture provision. At the least, the IRS should extend this analysis involving indemnity reinsurance to potentially treat reinsurance transactions meeting the section 197 requirements as section 351 transfers.

OTHER ITEMS OF INTEREST IN PLR

Other items of interest include representations and rulings on derivatives, market discount bonds and the application of the disproportionate asset acquisition rule in the life/nonlife consolidated return regulations, Treas. Reg. § 1.1502-47. In representations (H) and (CC), the taxpayer stated that for purposes of determining that the fair market value of transferred assets exceeds transferred liabilities, an "in the money" derivative is treated as an asset to the extent it is in the money and an "out of the money" derivative is treated as a liability to the extent it is out of the money. The representations also state that a derivative that is "at the money" is treated as neither an asset nor a liability. Representations (I) and (DD) contain similar statements that a derivative for which the present value of the payments that are anticipated to be received from the counterparty to the derivative contract is less than the present value of the payments that are anticipated to be made to the counterparty of the derivative contract is treated as a liability described in section 357(c)(3)(A). Section 357(c)(3)(A) provides that a liability is not included for purposes of section 357(c) if the liability the payment of which either would give rise to a deduction or would be described in section 736(a). Presumably, in this case, the net payments to the counter-

party under the derivative would give rise to a deduction to the transferee under Treas. Reg. § 1.446-3 or a similar provision. There is some guidance which suggests that a swap derivative is property (presumably meaning an asset rather than a liability) whether it is in or out of the money.[3] However, in Rev. Rul. 95-45, 1995-1 C.B. 53, the IRS concluded that the transfer of a corporation's obligation to provide replacement securities to a broker-dealer pursuant to a short sale was the assumption of a liability for purposes of sections 357 and 358 to the extent the transferor had a basis in the short-sale liability. In any event, the PLR appears to adopt an economic approach to the treatment of derivatives and whether they are assets or liabilities transferred in connection with section 351.[4]

Another set of rulings deals with the transfer of market discount bonds. Rulings (2) and (9) provide that no gain or loss will be recognized by the transferor, except that any gain on the transfer of a market discount bond, to the extent the gain does not exceed the accrued market discount on that bond as of the date of the exchange, will be recognized as ordinary income. The basis for this conclusion is section 1276(a) which provides for the recognition of gain on the disposition of any market discount bond notwithstanding other provisions of subtitle A, which gain is then treated as ordinary income to the extent it does not exceed the accrued market discount on such bond. It appears that this is the first time the IRS has included such a ruling in the context of a section 351 transaction.

The last interesting rulings, (14) and (15), deal with the application of Treas. Reg. § 1.1502-47(d) and the disproportionate asset acquisition rules. Treas. Reg. § 1.1502-47(d) provides certain requirements which must be satisfied so that a newly-formed or newly-acquired life insurance company can be eligible to join in a life/nonlife consolidated return. Treas. Reg. § 1.1502-47(d)(12)(vii) provides that a corporation must not undergo during the base period a disproportionate asset acquisition attributable to an acquisition of assets from outside the group in transactions not conducted in the ordinary course of its trade or business (special acquisitions). Among the factors and rules used to determine whether such an acquisition has occurred is the portion of premiums generated during the last taxable year of the base period which are attributable to special acquisitions. For purposes of applying Treas. Reg. § 1.1502-47(d)(12)(viii)(C), ruling (15) concludes that the assets transferred in the indemnity coinsurance transactions are not premiums received from special acquisitions. This favorable ruling applies only to the assets transferred in the indemnity reinsurance transactions since, presumably, as a result of the application of section 351 and Rev. Rul. 94-45 to the assumption reinsurance transactions, the subchapter L reinsurance rules were overridden and therefore there was no premium transferred and no need for a favorable ruling on the assumption transaction.

CONCLUSION

We hope that we have made a persuasive case for analyzing the underlying economics of the transaction to determine impact and classification rather than arbitrarily determining results based upon reinsurance transaction categories. The industry has evolved in its use of indemnity reinsurance—hopefully we will see the IRS develop the rules around section 351 transactions involving the transfer of insurance assets that address the ways indemnity transactions are used today in the industry.

END NOTES

1. *See, eg., Borggaard, Howard K.*, T.C. Memo. 1979-458 (1979), Rev. Rul. 73-16, 1973-1 C.B. 186.
2. Rev. Rul. 94-45, holding (3), concludes that the basis of the assets for section 357(c) purposes includes the transferred unamortized deferred acquisition cost.
3. For example, in FSA 1999-733 (Aug. 6, 1993), the IRS stated that, "It is the *Service's* position that an interest rate swap constitutes property in the ordinary sense. A swap can flip from an obligation to make a payment to a right to receive a payment, and back again. Cf., *e.g., Stavisky v. Commissioner,* 34 T.C. 140, 142 (1960). An interest rate swap constitutes a bundle of rights and obligations..."
4. In addition, Ruling (4) provides that the basis in the LifeCo5 stock is not reduced by liabilities described in section 357(c)(3). Therefore, it appears that the IRS did not apply section 358(h). That section generally requires a basis reduction in the stock received by a transferor (but not below fair market value) for the transfer of any liability which is defined in section 358(h)(3) as any "fixed or contingent obligation to make payment, without regard to whether the obligation is otherwise taken into account for purposes of this title." There are several exceptions in section 358(h)(2) whereby the basis reduction rule will not apply to the transfer of a liability. Section 358(h) was enacted in 2000 in response to the "Son of Boss" transactions.

Lori J. Jones is a partner with the Washington, D.C. law firm of Scribner, Hall & Thompson, LLP and may be reached at *ljones@scribnerhall.com.*

Julie Goosman is a partner with Pricewaterhouse-Coopers in Atlanta, Ga. specializing in insurance mergers and acquisitions tax and may be reached at *julie.v.goosman@us.pwc.com.*