Beneficial Life Insurance Company, Petitioner v. Commissioner of Internal Revenue, Respondent, 79 T. C. 627 (1982)

In reinsurance transactions, the assuming company must include in income the full reserve liability assumed, with different treatment for assumption and indemnity reinsurance.

Summary

Beneficial Life Insurance Company entered into various reinsurance transactions, including one assumption and seven indemnity reinsurance agreements. The IRS argued that the company should recognize income equal to the reserve liability assumed in each transaction. The court agreed, ruling that for assumption reinsurance, the excess of assumed reserves over the consideration received represents the cost of acquired business, amortizable over its useful life. For indemnity reinsurance, this excess is treated as a cost of issuing insurance, directly deductible from income. The court also clarified that adjustments under section 818(c) do not affect the income recognition of reserves for tax purposes.

Facts

Beneficial Life Insurance Company (Beneficial) engaged in one assumption reinsurance transaction and seven indemnity reinsurance transactions (five conventional and two modified coinsurance) during the tax years 1972-1976. In the assumption transaction, Beneficial assumed policies from American Pacific Life and Somerset Life, receiving a net payment less than the assumed reserve liability. In the indemnity transactions, Beneficial assumed liabilities from various ceding companies, receiving initial payments also less than the reserve liabilities assumed. Beneficial elected to revalue its reserves under section 818(c) for tax purposes.

Procedural History

The IRS issued a notice of deficiency to Beneficial, asserting that the company must include in income the full reserve liability for each reinsurance transaction. Beneficial contested this in the U. S. Tax Court, which heard arguments on the proper tax treatment of the transactions and the impact of the section 818(c) election.

Issue(s)

1. Whether the assuming company must recognize income to the extent reserve liabilities assumed exceed the initial consideration received?
2. If so, whether such excess is currently deductible or represents the acquisition of an asset, the cost of which is amortizable over the useful life of that asset?
3. What effect, if any, do adjustments made pursuant to section 818(c) have upon the amounts included in income?

Holding

1. Yes, because the full reserve liability assumed represents consideration received by the assuming company.
2. For assumption reinsurance, no, because the excess represents the cost of business acquired, amortizable over the useful life of that business. For indemnity reinsurance, yes, because the excess is treated as a cost of issuing insurance and is currently deductible.
3. No, because the section 818(c) election does not affect the income recognition of reserves for tax purposes.

Court's Reasoning

The court applied section 809(c)(1) to include in income the full reserve liability assumed as consideration for assuming liabilities under contracts not issued by the taxpayer. For assumption reinsurance, the excess of reserves over consideration received was treated as the cost of acquiring business, following the treatment of such transactions as sales. For indemnity reinsurance, this excess was treated as a cost of issuing insurance, directly deductible under section 809(c)(1) as return premiums. The court rejected the IRS's argument that section 818(c) adjustments should affect income recognition, noting that section 818(c) pertains to the method of calculating reserves for tax purposes, not to income inclusion.

Practical Implications

This decision clarifies the tax treatment of different types of reinsurance transactions, requiring life insurance companies to recognize income equal to the reserve liabilities they assume. For assumption reinsurance, companies must amortize the cost of acquired business, while for indemnity reinsurance, the excess of reserves over consideration received can be directly deducted. This ruling affects how life insurance companies structure reinsurance agreements and calculate their tax liabilities. It also underscores the importance of understanding the nuances of tax elections like section 818(c), which do not alter the income recognition of reserves but allow for different reserve calculations for tax purposes. Subsequent cases and tax regulations may further refine these principles.