ORIGINAL

OFFICIAL TRANSCRIPT PROCEEDINGS BEFORE

THE SUPREME COURT OF THE UNITED STATES

CAPTION: COLONIAL AMERICA LIFE INSURANCE COMPANY, Petitioner, v. COMMISSIONER OF INTERNAL REVENUE

CASE NO: 88-396

PLACE: WASHINGTON, D.C.

DATE: April 18, 1989

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Washington, D.C. 20001

IN THE SUPREME COURT OF THE UNITED STATES

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COLONIAL AMERICAN LIFE :
INSURANCE COMPANY, :
Petitioner, :
v. : No. 88-396
COMMISSIONER OF INTERNAL :
REVENUE :

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Washington, D.C.
Tuesday, April 18, 1989

The above-entitled matter came on for oral argument before the Supreme Court of the United States at 11:04 a.m.

APPEARANCES:

CAROLYN P. CHIECHI, Washington, D.C.; on behalf of Petitioner.

MICHAEL R. DREEBEN, Assistant to the Solicitor General, Department of Justice, Washington, D.C.; on behalf of Respondent.

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P R O C E E D I N G S

11:04 a.m.

CHIEF JUSTICE REHNQUIST: We'll hear argument next in No. 88-396, Colonial American Life Insurance Company v. Commissioner of Internal Revenue.

Ms. Chiechi, you may begin whenever you're ready.

ORAL ARGUMENT OF CAROLYN P. CHIECHI

ON BEHALF OF PETITIONER

MS. CHIECHI: Thank you, Chief Justice Rehnquist, and may it please the Court:

This case involves insurance, the type of insurance that is issued by one insurance company to another, and that is known as indemnity reinsurance.

Just as an insurance company normally incurs substantial expenses when it issues insurance to members of the general public, such as you and me, an insurance company also normally incurs substantial expenses when it issues indemnity reinsurance.

It is undisputed that the expenses of issuing directly written insurance are to be deducted currently. The issue that this Court must resolve is whether the expenses of issuing the type of insurance known as indemnity reinsurance are also to be deducted currently.

It is the position of the Petitioner Colonial American Life Insurance Company that just as the expenses of issuing directly written insurance are to be deducted currently, so are the expenses of issuing indemnity reinsurance. Section --

QUESTION: Well, one could phrase it differently. One could really ask whether this is an expense of -- when one pays the seller of the insurance what would normally be a commission if paid to a third party, whether that's an expense or not.

MS. CHIECHI: That is one way to phrase it, Justice Stevens.

QUESTION: Because it's clear if it is an expense, it's deductible currently. There is no quarrel about that.

MS. CHIECHI: No, Justice Stevens. But there is a specific provision that Congress provided in Part I of Subchapter L of the Code to deal with the ceding commission expense that is involved in indemnity reinsurance. Although you are right, Justice Stevens, that you also could have a deduction just as you have for directly written insurance under Sections 809(d)(12) and 162.

QUESTION: Ms. Chiechi --

MS. CHIECHI: Yes, Justice Scalia.

QUESTION: Do I say your name right?

MS. CHIECHI: Yes, Justice Scalia.

QUESTION: What -- what does an insurance company do by way of the expenses of an agent? It was my impression that an agent who writes a policy gets commissions over the term of the policy. As the policyholder pays the commission to the company, the company will reimburse the agent annually for -- you know, on the basis of the money received in the future.

It's not my impression that the insurance company would immediately seek to take a writeoff of future -- in a way, that is all expenditure that is incurred at the time that he brings the policyholder to the company, isn't it?

MS. CHIECHI: In the year that a directly written insurance policy is issued, an insurance company, in connection with what it would pay the sales agents incurs the sales agent's expense, sometimes in the range of about 60 percent of the initial premium on ordinary whole life insurance.

Thereafter, each year there is what's known as a renewal premium which is a much less percentage, which is paid only if the insurance is continued in force.

In the case of indemnity reinsurance and the particular insurance involved in this case, there was the initial ceding commission paid in a fixed amount and thereafter there was a requirement that the reinsurer, Colonial, pay a specified percentage of premiums thereafter. I believe it was about five percent in each of the agreements.

QUESTION: Oh, there was. I'd forgotten it.

MS. CHIECHI: Yes. Yes.

QUESTION: And so you think it's about equivalent to what they do with the --

MS. CHIECHI: In the regard that you were raising. Yes, absolutely.

If I may continue. As I was saying, there is a specific provision in Part I of Subchapter L of the Internal Revenue Code as amplified by the regulations. And that is Section 809(c)(1) which requires that the ceding commission expense involved in this case be deducted currently.

The Commissioner concedes that indemnity reinsurance, like directly written insurance, is the issuance of insurance. With one exception, he does not dispute that the provisions of Part I of Subchapter L treat indemnity reinsurance as the issuance of insurance. And it is this one exception that relates to the issue in this case.

According to the Commissioner, he would like this Court to treat indemnity reinsurance like directly written insurance in all respects except with respect to the expenses of issuing that insurance.

In support of this position, the Commissioner contends that some so-called general or fundamental tax principle is controlling, and requires that such commissions be capitalized and amortized.

In support of his position, the Commissioner says that just as an insurance company in an assumption reinsurance transaction acquires an asset consisting of insurance policies which will generate a future income stream, so does an indemnity reinsurer when it issues its reinsurance contract acquire an asset consisting of a future income stream and that therefore the ceding commission is paid to acquire that asset.

QUESTION: Ms. Chiechi --

MS. CHIECHI: Yes, Justice O'Connor.

QUESTION: -- would you explain to me how you read 809(c)(1). Now, that's a section of the Code that talks about premiums.

MS. CHIECHI: Yes, Justice O'Connor.

QUESTION: And yet you say that it incorporates this whole concept of deduction of ceding --

MS. CHIECHI: Section 809--

QUESTION: -- commissions.

MS. CHIECHI: Excuse me, Justice.

QUESTION: Now, do you say that this is a return premium or do you say it's other consideration arising out of reinsurance ceded?

MS. CHIECHI: We believe it's both but you need not reach the second phrase in the statute, Justice O'Connor, because clearly the term return premium, as amplified by the regulations under Section 809(c)(1) provides that the term return premiums is to include amounts of premiums or other consideration returned to another life insurance company in respect of --

QUESTION: Well, the government says the words "return premiums" apply only to premium income which either an initial insurer or a reinsurer has to return to the policyholder due to mortality experience or other contractual obligations. That it just doesn't include --

MS. CHIECHI: That --

QUESTION: -- ceding commissions.

MS. CHIECHI: That assertion I believe is unfounded. I have found no support for it in the statue, which is clear on its face, and the regulations under the statute, or in the legislative history.

Concededly, in connection with another provision, Congress made the observation in the Senate Finance Report that returns by life insurance company respective indemnity reinsurance, which also cover experience refunds -- but the regulations which amplify the meaning of the term return premiums have no such qualification in them whatsoever.

QUESTION: Well, do you argue that the last clause in premiums and other consideration "arising out of reinsurance ceded" would cover your case if return premiums do not?

MS. CHIECHI: We believe that it could --

QUESTION: Do you argue that in your brief?

MS. CHIECHI: We don't -- we don't elaborate on that argument, Justice Kennedy, because we believe that it's clear that return premiums cover the ceding commissions, but -- and, therefore, that you wouldn't have to reach the second phrase. But we think the second phrase equally could cover it.

QUESTION: What about the phrase "arising out of reinsurance ceded," does that modify return premiums?

MS. CHIECHI: No. No, Justice. Return premiums -- there is a comma after return premiums in the --

QUESTION: And do both parties agree on that?

MS. CHIECHI: I cannot speak for counsel for the Commissioner.

QUESTION: All right.

QUESTION: Counsel, in the long-run as a practical matter, would you -- will you be better off with deductibility or with amortization? Do you know?

MS. CHIECHI: In the long run? I'm really not sure. The Code clearly provides for current deduction. I'm not sure what your question is getting at, Justice.

QUESTION: What you're really arguing about is the tax years in question.

MS. CHIECHI: Yes.

QUESTION: If you lose the case, you may prevail dollar-wise over the long-run. This is often true in tax cases, isn't it?

MS. CHIECHI: Well, if what you are suggesting is that this is a question of timing, that is true. But it's a timing that Congress considered and that Congress required the timing be controlled by Section 809(c)(1).

QUESTION: Was your tax court decision, incidentally, reviewed by the full court?

MS. CHIECHI: No, it was not, Justice.

QUESTION: Is there a similar decision on the point that was reviewed by the full court?

MS. CHIECHI: I don't believe there is any decision of the tax court that's been reviewed by the full court, but there have been, I think, five decisions that have been handed down since the first case, Beneficial Life, in 1982 decided this question.

QUESTION: The legislative history argument that you make seems to have occurred only in a discussion of the nature of indemnity reinsurance dealing with the problem of double taxation of modified coinsurance agreements.

I'm not sure that the history you refer to really occurred in the context that this case arises.

MS. CHIECHI: Well, that proves our point, Justice O'Connor, in that Congress believed that the rules it otherwise prescribed in Part I of Subchapter L govern indemnity reinsurance just as they govern directly written insurance.

But it realized that in the case of a certain type of indemnity reinsurance, what's known as modified coinsurance, if you applied those rules as they were written, you might have the potential for double taxation. And so that is why Congress enacted Section 820. And I think that's to me just a reaffirmance of its intention that the rules otherwise applied it to directly as well as indemnity reinsurance.

If I may continue. As I have said, there is a specific provision in the Code, Section 809(c)(1) which we believe clearly allows the current deduction in calculating premium income of ceding commissions.

But just as the expenses of issuing directly written insurance are currently deductible under Section 809(d)(12) which incorporate Section 162 of the Code, we believe that the expenses of issuing indemnity reinsurance, the ceding commission, in the alternative, is also deductible under Section 809(d)(12) and 162.

The Commissioner disagrees and he tries to argue that any analogy between ceding commissions and indemnity reinsurance and the agent's commissions in directly written insurance is a false analogy. That contention is unfounded and misses the point.

The point is that ceding commissions incurred in issuing indemnity reinsurance are the normal usual expenses that an insurance company incurs when it issues insurance to another insurance company.

Agents' commissions incurred in connection with directly written insurance are the normal usual expenses incurred by an insurance company.

QUESTION: Yes, but there is this difference, and I wish you would comment on it a little bit. In the reinsurance situation, the insurance company that is in effect buying the insurance is the recipient of the commission. Whereas, in the ordinary original insurance situation, the agent who receives the commission is the nature of a third party.

And it is very unusual to say that when you pay someone a consideration because he's selling you something, that that's like a commission. It's a very different situation.

MS. CHIECHI: Well --

QUESTION: It's in effect a change in the purchase price.

MS. CHIECHI: Well, in a sense it is a price rebate, when you have just two parties involved.

QUESTION: Right.

MS. CHIECHI: And we are not suggesting in any way that three parties is necessary to resolve this issue. In fact, you can have a sales agent who sells himself insurance and he still gets the commission from his insurance company.

Whether you have two-party or three-party is irrelevant to resolution of this issue, and in fact probably why Congress put this provision for the ceding commission part of the expense and indemnity reinsurance in 809(c)(1) was precisely because it was in a sense a price rebate and -- in the context of a two-party situation.

QUESTION: May I ask you another question. Is it clear that the recipient of the ceding commission would have that -- the commission taxable as ordinary income?

MS. CHIECHI: Yes, it would be includible in --

QUESTION: Your opponents don't disagree with that, do they?

MS. CHIECHI: Not as far as I'm aware.

QUESTION: It's funny. Nobody seemed to discuss that. But one would --

MS. CHIECHI: In a footnote in our reply brief we point that out.

QUESTION: Thank you.

QUESTION: Can the reinsurance contract be cancelled by the reinsurer?

MS. CHIECHI: No, it cannot be.

QUESTION: Well, that's a difference also in this transaction and the policy of direct insurance, isn't it? Because usually the insured can cancel.

MS. CHIECHI: I'm sorry. I thought you said the reinsurer.

QUESTION: In your -- in the case we're talking about can the reinsurance company cancel --

MS. CHIECHI: I'm sorry, Justice Kennedy --

QUESTION: -- the contract?

MS. CHIECHI: -- when you say reinsurance company, are you talking about the ceding company, the policyholder?

QUESTION: No, not the ceding company. The company that buys the reinsurance. The reinsuring company.

MS. CHIECHI: The reinsurer cannot cancel any more than a life insurance company can cancel a life insurance policy that you've purchased.

QUESTION: Right.

MS. CHIECHI: If I may continue, the result which we urge in this case, the 809(c)(1) requirement that the ceding commission be excluded in full in the year in which it is paid, or, alternatively, that 809(d)(12) and Section 162 would require the same result, is totally consistent with the manner in which insurance companies would treat the commission under any NAIC accounting. That is, the accounting prescribed by the National Association of Insurance Commissioners.

QUESTION: Ms. Chiechi --

MS. CHIECHI: Yes, Chief Justice Rehnquist.

QUESTION: In the government's brief and in your brief, too much is made of the distinction between indemnity reinsurance and assumption reinsurance. The government says that everybody agrees that -- and if you're dealing with assumption reinsurance, the commissions would have to be treated differently.

What, in short, is the difference between assumption reinsurance and indemnity reinsurance?

MS. CHIECHI: Indemnity reinsurance is like directly written insurance. It's the issuance of insurance and the beginning, then, of a continuing insurance relationship.

QUESTION: It's really a novation between the second --

MS. CHIECHI: No. Not indemnity reinsurance.

QUESTION: No?

MS. CHIECHI: There is a separate insurance policy that is issued by the reinsurer in indemnity reinsurance to its policyholder, the ceding company. That insurance contract does not alter or disturb in any way the other existing insurance relationship between the ceding company and its policyholders.

In contrast, in an assumption reinsurance transaction, one insurance company acquires existing insurance contracts and therefore acquires the position or the relationship of the selling company in --

QUESTION: That is a novation and --

MS. CHIECHI: Yes.

QUESTION: -- that is a new deal between --

MS. CHIECHI: Yes.

QUESTION: -- the second insurance company and the policyholder.

MS. CHIECHI: Yes. Exactly.

QUESTION: Is it really a novation? Is the original insurance company off the hook as far as the policyholder is concerned?

MS. CHIECHI: It is generally considered to be a novation. There are some jurisdictions where there is a secondary liability by the selling --

QUESTION: I would think so.

MS. CHIECHI: But generally it is --

QUESTION: How can you --

MR. DREEBEN: -- considered --

QUESTION: You normally can't get out of a contract with me by just giving it to somebody else and writing me a letter saying you --

MS. CHIECHI: If the policyholders consent, Justice Scalia, and there are in fact --

QUESTION: If they consent, then there would be a novation?

MS. CHIECHI: Yes. Yes. As I was saying, the treatment urged by Colonial is totally consistent with NAIC accounting, and, therefore, we believe that the requirement of Section 818(a) of the Code, as interpreted by this Court in the Standard Life case, is fully satisfied because NAIC accounting is to apply except where the rules of accrual accounting require a different result.

Now, the Commissioner argues that NAIC accounting does not apply because the rules of accrual accounting require that -- and this is his phrase --"the acquisition costs of a future benefit be capitalized."

In support of that argument, he relies on a regulation under Section 461 that applies to accrual method taxpayers.

The Commissioner is wrong in suggesting that the requirement to capitalize so-called acquisition costs of a future benefit is a rule imposed by accrual method accounting. That is a rule that is imposed by a regulation under Section 446 of the Code and it applies regardless of the method of accounting that the taxpayer is on. Whether you're on accrual method, cash method, or any other method.

And the Commissioner is just misleading in suggesting that because that requirement appears in the regulation under Section 461, applicable to accrual method taxpayers, that it's an accrual method rule, because the same requirement appears in the 461 regulations that apply to cash method taxpayers.

But, of course, this case does not involve acquisition costs of a future benefit. It involves indemnity reinsurance and the ceding commissions incurred in issuing that insurance.

The rules of accrual accounting do not speak to the character as a currently deductible expense or as a capital item of the ceding commissions incurred in issuing indemnity reinsurance, any more than they speak to the character as a currently deductible expense or as a capital item of the expenses incurred in issuing directly written insurance.

In fact, if the Commissioner were correct that the rules of accrual accounting require that ceding commissions in indemnity reinsurance be capitalized, they would also necessarily require that directly written expenses be capitalized.

Yet, he agrees here, as he always has, that the expenses in issuing directly written insurance are to be deducted currently. And thus he concedes that the rules of accrual accounting do not require a contrary result.

This Court should not countenance the Commissioner's disregard of the special provisions in Part I of Subchapter L which are based on NAIC accounting. The Commissioner's disregard of those rules simply should not be countenanced here.

Resort to some general or fundamental tax principle that might be applicable to any other taxpayer in any other setting to resolve the tax treatment of the

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ceding commissions involved in this case will produce an unsound result that is contrary to Part I of Subchapter L, the legislative history, and the regulations thereunder.

I would like to reserve time for rebuttal. Thank you.

CHIEF JUSTICE REHNQUIST: Very well, Ms. Chiechi.

Mr. Dreeben.

REBUTTAL ARGUMENT OF MICHAEL R. DREEBEN

ON BEHALF OF RESPONDENT

MR. DREEBEN: Thank you, Mr. Chief Justice, and may it please the Court:

A ceding commission is paid to acquire a future stream of income from a block of life insurance policies. Under well-established tax principles, that kind of an outlay is capital in nature and cannot be deducted in full in the year incurred.

There is no provision in the Life Insurance Company Income Tax Act of 1959 that overrides this fundamental rule to allow --

QUESTION: May I ask -- because I want to be sure I find this out at the beginning.

MR. DREEBEN: Yes, Justice Stevens.

QUESTION: Is the receipt of the ceding

commission taxable as ordinary income?

MR. DREEBEN: To the ceding company it is. That's correct.

QUESTION: Then why isn't the government kind of getting -- getting it both ways in a sense.

MR. DREEBEN: Well, it's not unusual, your Honor, for a receipt of a payment for an asset to be taxable in full in the year that it's received. So, I don't think that this is a departure from --

QUESTION: No, but that would normally be taxable as a capital gains, of course. But normally if you have an item paid to a third-party agent, or something like that, if it's an expense to the payer, it's normally income to the payee and vice versa. Isn't it? Or maybe I'm --

MR. DREEBEN: Well, I don't think that there is any necessary parallelism between then. As to the capital gains point, there are many, many situations where one party pays an acquisition cost and has to amortize it and the other party has to receive the income and pay taxes on it in the year of receipt.

Here the capital gains question doesn't arise at all because Congress has specifically provided that the sale of an insurance policy is not subject to favorable capital gains treatment. It has to be taxed on ordinary income basis.

So there really is no connection whatsoever between the tax treatment for the ceding company and --

QUESTION: Can you give me another example? You say there are many of them. I just don't know that much about tax law.

Another example in which a payment of this character would be ordinary income to the recipient and not deductible to the payer.

MR. DREEBEN: I think you can imagine many situations that would be somewhat similar. Whether all of these happen in the real world is unclear. But if --

QUESTION: Can you give me an example that happens in the real world?

MR. DREEBEN: Well, take, for example, an auto company that sells cars and takes installment loans back from its customers and then discounts those loans away to a third party that purchases the loans today, giving the car company that sold the loans a slightly smaller amount of money than the face value of the loans to reflect the time value of the money.

The car company that receives the money would have to take that into income in the year it's received. On the other hand, the discounter who purchases the notes would have to amortize its purchase price over the life during which the notes were expected to produce income.

So, that is an example which is in many ways parallel to the situation that we have here because Petitioner entered into this transaction and agreed to pay a ceding commission precisely because it anticipated receiving future profits in the form of premium and other income from the block of policies that it reinsured.

This isn't just the Commissioner's point of view about the matter. This is what the record unequivocally shows was Petitioner's anticipated benefit when it entered into this transaction.

There is an exhibit, Joint Exhibit 6-F, Part 8, which was entered into the record in the tax court, which was a letter from an actuary proposing this transaction to Petitioner and informing Petitioner about the potential benefits that it might realize.

And it wrote, "These reinsurance treaties have been constructed to minimize loss to Colonial American. This is a seasoned and predictable block of business with virtually all policies over five years old. A computer projection of future profits was made and that projection showed that Colonial's pre-tax profit on the reinsurance transaction will be about $80,000."

And the letter concluded on this basis. "The transport reinsurance arrangement should be a safe and profitable investment."

And I submit that that is not what anyone has in mind when one talks about an insurance company writing a policy of insurance.

An insurance company does not view the policy of insurance as a safe and profitable investment the way Petitioner did when it paid a ceding commission to acquire rights from a block of policies that would produce income for it stretching over a period of seven years, in this case.

There are many contexts where this Court has considered basic rules of capitalization as they apply to companies in a variety of industries. And at bottom the question always comes down to whether there has been a purchase price paid for the acquisition of a future benefit that will stretch more than one tax year.

QUESTION: Well, I would think that your arguments could be made equally with regard to the original insurance company in the deduction of commissions. It just seems to me that your theory would be equally applicable there. And yet Congress has chosen to allow the immediate deduction --

MR. DREEBEN: That's correct, Justice --

QUESTION: -- of the commissions.

MR. DREEBEN: -- O'Connor. Well, I agree, first of all, that the theory is applicable to agent's commissions. And the only reason why agent's commissions are not required to be amortized over the life of the policy is because Congress has specifically and unequivocally indicated in legislative --

QUESTION: Right.

MR. DREEBEN: -- materials that they are not to be.

QUESTION: And you can read 809(c)(1), as the taxpayer reads it, as an indication that Congress likewise intended to make the same provision for reinsurance ceding commissions.

MR. DREEBEN: Well, Justice O'Connor, I don't think that there is anything in the background of 809(c)(1) or in its language that directly covers a ceding commission.

QUESTION: Well, it says less return premiums and premiums and other consideration arising out of reinsurance ceded.

I mean, you certainly can read it the way the taxpayer does, and five different tax court panels have so read it.

And you've got a Treasury regulation that includes within the definition of returned premiums amounts of premiums or other consideration returned to another life insurance company in respect to reinsurance ceded.

I mean, you can certainly read that as support of the taxpayer position. So, it's a little hard to understand -- I mean, I can understand your argument as a matter of policy. But it certainly can support the taxpayers and the tax courts' view of this thing.

MR. DREEBEN: Well, let me make two points in response to that, Justice O'Connor. First of all, I do think that the plain language of the regulations can be read to support our position and not their position.

But it's very important in construing a fairly technical Tax Act, such as this, to take a look at the problems that Congress had identified and was trying to solve when it wrote the sections that are in question.

Now, as you pointed out, in Petitioner's argument 809(c)(1) is focused on the determination of premium income to an insurance company. And then it provides for certain deductions.

The theory of the case that we presented -- and two courts of appeals have written opinions extensively that accept this theory -- is that that provision was designed to allow insurance companies to eliminate from their premium income amounts that with the benefit of hindsight never would have been included in it in the first place because they were amounts that a company turned over to a second company to obtain indemnity reinsurance or they were amounts that had to be paid back to policyholders.

And that's what Congress meant by return premiums.

It didn't mean the purchase price of an income stream from a block of policies in a fairly complicated indemnity transaction. And I say that for several reasons.

First of all, there is absolutely nothing in any of the legislative materials or the hearings that's been pointed out by any party to this case in the years of litigation that shows that Congress ever thought about ceding commissions, let alone thought about them in the fashion that Petitioner suggests as somehow analogous to agent's commissions.

They're really not analogous to agent's commissions at all. They are payments that are made directly to the person who is in the position of the policyholder, according to Petitioner's theory.

QUESTION: Mr. Dreeben, what does that other phrase in -- in (c)(1) mean in your estimation?

Premiums and other consideration arising out of reinsurance ceded. What does that refer to?

MR. DREEBEN: That was designed, Justice Scalia, to cover the situation when the initial insurer pays money over to a second insurance company to obtain indemnity reinsurance. It covers only monies that flow one way.

And the reason that that construction is appropriate is the language that you have identified. Consideration arising out of reinsurance ceded appears not once, but twice, within the same Section 809.

In 809(d)(7) Congress used -- and that language is set out in our brief at the appendix on page 2 and 1 -- that language was used in a context that permits no other reading than as a payment that's made by the initial insurer to a second company.

It's our position that when Congress deliberately uses the same language in two phrases that so closely enjoin each other that no other reading is really appropriate but that they be given the identical meaning.

The reason that it becomes clear that 809(d)(7) --

QUESTION: Now, wait. You're talking about money going from the ceding company to the acquiring company?

MR. DREEBEN: Yes, that's correct, your Honor.

QUESTION: I thought the money goes the other way.

MR. DREEBEN: Well, in this transaction it does and that's we say that that --

QUESTION: When doesn't it?

MR. DREEBEN: It doesn't, for example, when an insurance company purchases something called yearly renewable term reinsurance, which is much like what everybody thinks of as an insurance contract. The policyholder pays money to the insurance company.

This case is somewhat unusual in that it involves an insurance company paying money to someone who Petitioner says is the insurance policyholder.

QUESTION: But that is still considered reinsurance ceded --

MR. DREEBEN: That's correct.

QUESTION: -- when you're buying just an annual renewable term policy?

MR. DREEBEN: That's correct. There are several different kinds of indemnity reinsurance that all fall within the rubric of reinsurance ceded.

QUESTION: Okay.

MR. DREEBEN: This is one and so is yearly renewable term.

QUESTION: Can those payments by the initial insurer ever be called return premiums, or are they under this second clause that you're discussing?

MR. DREEBEN: They're under the second clause, Justice Kennedy. They're not return premiums.

What Congress had in mind by return premiums were payments that were made, for example, when a policyholder has paid a premium but he dies before the coverage has fully been given so some of the premium is paid back to the estate. Or, the policy premium was incorrectly calculated in the first place so that there is a rebate paid to the policyholder.

It's those sorts of figures that one truly would never look at as income to the insurance company in the first place had they not been mistakenly paid. When they are paid back, they're return premiums and they're used as a vehicle for the insurance company to eliminate that amount from its gross income.

QUESTION: May I ask one other question?

MR. DREEBEN: Yes, Justice --

QUESTION: Would you agree that for some purposes the Code does draw a distinction between indemnity reinsurance transactions and assumption reinsurance transactions?

MR. DREEBEN: Yes, it clearly does in several different places.

QUESTION: Does it -- for example, in an assumption reinsurance transaction I take it the money received by the ceding company is not taxable as ordinary income. Is that right?

MR. DREEBEN: The money received --

QUESTION: A ceding company -- for something equivalent to a ceding commission would not be taxable in that transaction as ordinary income to the ceding company?

MR. DREEBEN: No. It would be taxable as ordinary income.

QUESTION: Put it in that --

MR. DREEBEN: Yeah. There is no capital gain provision at all that's applicable for insurance policies. They were deliberately excluded from the coverage of favorable capital gains treatment.

QUESTION: So that even if it's a capital transaction, the selling company -- the receipt of the ceding commission by the selling company would be ordinary income?

MR. DREEBEN: That's correct.

QUESTION: I see.

MR. DREEBEN: It's harder to say how the

question would have come out had Congress not specifically written a rule that prevented these sales of insurance policies from being treated as capital gain, but it did that to avoid the favorable effects to the ceding companies in these --

QUESTION: Could you tell me one -- just an example of a difference in tax treatment between the two kinds of transactions?

MR. DREEBEN: Between the assumption transactions --

QUESTION: And the indemnity reinsurance. Yes.

MR. DREEBEN: Well, one difference that Petitioner has made much of is the provision under which a ceding company in either transaction can deduct its payments to the reinsurer.

Congress provided that the ceding company in an indemnity transaction deducts them under 809(c)(1) and in an assumption transaction it deducts them under 809(d)(7), I believe.

There's an explanation for that that has absolutely nothing to do with the taxation of the ceding commission with respect to the buying company. The explanation is that in an indemnity reinsurance situation the initial insurer essentially serves as the conduit for the premiums. He continues to receive premiums --

QUESTION: Right.

MR. DREEBEN: Pays some of them over to the reinsurer, and so he uses the same section of the Act to neutralize the effect of the receipt of those premiums.

An assumption reinsurer doesn't have the benefit of continued receipt of premiums so it needs a separate section or it wouldn't be able to deduct the premiums that it pays over to a reinsurer at all.

And the other sections that are relied on by Petitioner have similar explanations that have absolutely nothing to do with the ceding commissions.

The distinctive feature of --

QUESTION: Mr. -- to say that the sections relied on by Petitioner have nothing to do with it -- you don't deny that the language that we've been talking about could fairly be read to include those -- just reading the language itself -- do you?

MR. DREEBEN: Well, I don't think so as to return premiums. No, your Honor. And the reason for that is these ceding commissions are not essentially being returned to the initial insurer at all. They are an up-front agreed-upon purchase price that is paid over at the outset of the transaction and is the very reason why the transaction happens. It's the consideration that's paid for it.

So, I don't think that it's a fair reading of the words "return premium" to say that it fits within that language.

QUESTION: How about "and other consideration arising out of reinsurance ceded"?

MR. DREEBEN: Well, I think that that language is sufficiently flexible so that a lot of different readings could be given to it. Had not Congress expressly chosen to use it twice -- to use it once in 809(c)(1) and once in 809(d)(7) -- and in the first context it may have some ambiguity as to who can avail oneself of that section. But in 809(d)(7) it's clear, in light of the legislative history, that Congress saw that as a section for initial companies to deduct payments that they make --

QUESTION: Do you set forth 809(d)(7) in your brief?

MR. DREEBEN: Yes. It's in the appendix. I think at the bottom of the page, page 1(a), and carries over to page 2.

QUESTION: What a strange way to say it. Why wouldn't they just say other than premiums and other consideration paid for reinsurance ceded, or something of that sort?

MR. DREEBEN: I think that the language --

QUESTION: Arising out of -- I would think that it -- it reverses who is getting the consideration.

MR. DREEBEN: Well --

QUESTION: What a strange way to say it.

MR. DREEBEN: The language could probably have been written better by Congress to clarify its meaning, but --

QUESTION: If they meant what you say they meant.

MR. DREEBEN: Well, they clearly meant it too because they wrote in the legislative history discussing the (d)(7) section in absolutely unmistakable terms that it refers to a payment from an initial insurer over to a second company.

QUESTION: And that's a consideration arising out of -- right?

MR. DREEBEN: Yes.

QUESTION: All right.

QUESTION: And doesn't the Treasury regulation define return premiums for us in a way that supports the taxpayer's view here?

MR. DREEBEN: No, I don't think so, Justice O'Connor.

QUESTION: Well, you can sure read it that

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way. Just like you can read this second phrase here that way.

MR. DREEBEN: Well, there's several points. First of all, the Treasury Department never wrote this section having any indication that it would be used to cover ceding commissions. It was responding to a very different and a very specific problem. A problem that actually resulted in the addition of the second sentence of 809(c)(1) to that section.

The problem there is a fairly intricate one. It relates to the distinction between dividends and return premiums for purposes of deduction under this aspect of the Life Insurance Company Tax Act.

Congress wanted basically to make clear that an insurance company could not take all of its investment earnings and redistribute them back to its policyholders, call them return premiums and deduct them all in the year that they were paid. That would allow insurance companies to escape taxation on that investment income, which Congress distinctly wanted not to be the case.

It did, however, also want there to be a second kind of payment that would be deductible. And that kind of payment was known as an experience refund. It reflects -- it occurs only in contracts between one insurance company and another, like the kind that we're dealing with here.

And that kind of provision allows the stream of premium income to be adjusted if the parties essentially miscalculated in how much income was going to be flowing over to the second company. And it adjusts that on the basis of experience.

Now, the legislative history makes clear that even though dividends aren't deductible in full, these kinds of experience refunds are deductible. And it deliberately chose to put language in the statute that would achieve that result.

And that language is copied virtually verbatim into the regulation that you're referring to.

So, I think that read in light of the history of the problems that Congress had in mind that it identified and the specific language that it chose to solve them, it would be misconstruing the statute to stretch its language to cover a kind of payment that was never intended to be covered by it.

QUESTION: In any of the five tax court decisions that gave a ruling in favor of the Petitioner, did the tax court rely on the second clause, the "arising out of" clause?

MR. DREEBEN: No, Justice Kennedy. It relied on the return premium clause and on the Secretary's regulation. It relied very little on anything else.

It then drew a sort of rough analogy between agents' commissions that are initially deductible in a single sale of an insurance policy and the ceding commissions here. It didn't subject that analogy to any kind of rigorous analysis. It never seemed to be bothered by the fact that the ceding commission goes to the person who is presumably the insurance policyholder, and it just left to the conclusion that these are currently deductible.

We think that it would draw an inappropriate distinction between assumption reinsurance transactions and indemnity reinsurance transactions to allow the reinsurer in the indemnity field to have an immediate deduction where the assumption reinsurer does not get an immediate deduction.

Both of them get essentially the same economic benefits and economic obligations as a result of the transaction. And both of them pay a ceding commission in order to acquire those benefits.

If it's capital in one context, it's capital in the other context, and both of them should be treated the same.

QUESTION: But isn't there the distinction that

Justice Scalia mentioned earlier? That in one case the company acquires the direct relationship with the original policyholders and not in the other case.

MR. DREEBEN: That's true, Justice Stevens. There is that difference in the form of the transactions. But it really doesn't have a lot to do with the economic benefits that the reinsuring -- the reinsurer pays for it when he pays a ceding commission. In either case it's paying the ceding commission so that it can get a stream of future income arising out of a block of policies.

For example, if in the assumption context the assuming reinsurance company contracted with some third party to deal with the policyholders -- and, in fact, contracted with the initial insuring company and said, "Look, continue as a manager for us for these policies, collect the premiums, pay them to us, pay the benefits, the policyholders never have to know about this," that shouldn't make any difference to the tax treatment of the ceding commission because in both cases it serves to create an identifiable economic benefit for the second insurance company that's going to stretch over a period of many years.

QUESTION: Of course, I think one could argue in the same way, that they should treat the two kinds of reinsurance as the same for all purposes. But we don't do that.

MR. DREEBEN: Well, there are reasons to distinguish between them based on the fact that the forms of the transactions do have some differences. But Congress drew those distinctions where it found them relevant to draw them. It was aware of the two kinds of insurance contracts and it crafted various provisions, which Petitioner cites, that draw those distinctions.

The question has to be asked: why didn't it draw one here? Why did it not write a distinction here?

QUESTION: Well, it is understood -- or, agreed by both parties that Congress really didn't think much about ceding commissions?

MR. DREEBEN: Well, I think it's fair to say that Congress did not think a lot --

QUESTION: Yes.

MR. DREEBEN: -- about ceding commissions, and that really undermines the suggestion that the broad and open-ended language of 809(c)(1) be read to cover a problem that Congress never really had in mind when it clearly had other problems that it was deliberately writing to address.

The final provision that is relied on by Petitioner to support a deduction of these ceding commissions is the accounting provisions of the Life Insurance Company Tax Act that were addressed by this Court in the Standard Life case.

I think the most basic response to that argument is that this really isn't an accounting question at all. This is a question that the court is quite familiar with and has seen in a number of other contexts in a number of other occasions.

It's a question of whether a payment creates a capital, intangible asset or simply represents an ordinary business expense. And that kind of fundamental classification decision is one that's drawn in the substantive sections of the Code. It's not something that's just simply given over to the accounting sections.

If Petitioner's position were correct, then the NAIC could designate any kind of capital outlay as an immediately deductible expense. And it might have good reason for doing it for NAIC purposes. It might feel that that better protects the solvency of the company for purposes of protecting the insurance policyholders.

But there would be no reason for Congress to have wanted to abdicate entirely all of the provisions of the Tax Code to the way the NAIC sets up its books.

However, if this Court does view the question in this case as having something to do with Section 818, the accounting provisions, then there is a body of federal tax accounting doctrine that one can look at that determines that a payment made for future outlays is not an immediately deductible expense. And that regulation, which is Regulation 1.461, is cited in our brief at page 39. Petitioner quoted it; I won't quote it again.

It is a rule that's applicable to all accrual taxpayers. It's so fundamental a tax accounting rule that the Secretary also made it applicable to cash basis taxpayers. But that doesn't undermine the fact that it still applies to taxpayers in the accrual system.

So, we do not think that 818 provides any basis for the deduction of these ceding commissions.

If the Court has no further questions --

QUESTION: I'm fascinated with this language of (c)(1). Suppose -- Suppose I'm an insurance company and I have policies and I want to reinsure some of the policies for three years. All right? I just want to buy reinsurance so if I have to pay out any money, I'll get reimbursed for at least part of it. And I buy a three-year reinsurance policy from another insurance company.

Under (c)(1) would I deduct all of -- and I pay up front for the whole three years -- would I deduct that in the current year or would I -- would I -- would I take the deduction over three years?

MR. DREEBEN: This would be a payment that covers years for which premiums have not yet been --

QUESTION: Not yet been paid.

MR. DREEBEN: -- received?

QUESTION: Right.

MR. DREEBEN: I would think that it would have to treat it as a deferred expense and not deduct it all in the year in which it paid it.

It can't -- nobody can accelerate all of their deductions by paying them all at once. I can't pay 15 months of my mortgage in this year and deduct them all on my current tax return. And that's in effect what this would be doing.

QUESTION: All right.

MR. DREEBEN: So, that I do not think would be a permissible result.

QUESTION: And that -- that's consistent with your position at the other end?

MR. DREEBEN: Yes, I think so, because at the other end it's simply saying that the ceding commission reflects identifiable benefits over many years so it has to be allocated to the years in which the benefit is produced.

Thank you.

CHIEF JUSTICE REHNQUIST: Thank you, Mr. Dreeben.

Ms. Chiechi, do you have rebuttal?

REBUTTAL ARGUMENT OF CAROLYN P. CHIECHI

ON BEHALF OF PETITIONER

MS. CHIECHI: Yes, Chief Justice Rehnquist.

The problem with the Commissioner's argument is that it starts from the wrong premise and it goes in the wrong door and it's going to come out the wrong end.

It starts from the premise that indemnity reinsurance is the acquisition of an asset, and in getting to that conclusion the Commissioner focuses on just one aspect of indemnity reinsurance, the right to future premium income assuming the policy stays in force.

This is what directly written insurance is all about as well. There is an expectation of receiving future premium income. And yet it's not correct to focus only on that aspect of directly written insurance and cut it up, slice it up, and say, well, just because you have this future premium income that you expect to get, that somehow you're acquiring an asset. And it's no more correct to do that in indemnity reinsurance.

The Commissioner's counsel also points to a document in Joint Exhibit 6-F, Part 8 --

QUESTION: Excuse me.

MS. CHIECHI: Yes, Justice.

QUESTION: The government points out that Congress has explicitly provided that you do not treat agent's commissions the way the government urges this ought to be treated.

MS. CHIECHI: The reason why -- what the counsel said was that the reason why directly written expenses are currently deductible is because of some provision in the Congressional legislative history of Part I, Subchapter L.

I do not agree with that. If the reason why expenses incurred in directly written insurance are currently deductible is because the ordinary and necessary expenses under Section 162 and Section 818 says that unless contrary to accrual accounting rules, the NAIC accounting is to apply, and directly written expenses are currently deductible in NAIC accounting.

The legislative history on which the counsel relies states as follows, "Small, new and growing life insurance companies are particularly likely to have underwriting losses because of the initial costs which they incur such as agents' commissions in placing new policies on their books."

Well, these are costs in this case which are incurred in placing new policies on the books of the indemnity reinsurer and the reference to "such as agents' commissions" is by no means an all-exclusive reference.

QUESTION: Yes, but you keep going by the fact that the agent's commission is paid to a third party. It's like paying a salesman.

Here the amount is in effect a rebate to the reinsuring company. That's quite a different situation on its face, it seems to me.

MS. CHIECHI: It's different, but it's not relevant to the determination here. And, in any event, as I said before, Justice Stevens, --

QUESTION: It does seem like a discount from the purchase price of --

MS. CHIECHI: And a price rebate. And that's why I think Congress put it in under 809(c)(1). It's a return premium to reduce the price otherwise that would be paid in the two-party situation.

QUESTION: But you can't deduct all of the purchase price in one year, can you? If you are purchasing insurance -- if you're buying a stream of income in the form of the second company buying from the first company, you couldn't deduct all the purchase price in the first year?

MS. CHIECHI: But that's not what indemnity reinsurance is about. Indemnity reinsurance is not acquiring an asset any more than directly written insurance is acquiring an asset.

The reference to this exhibit where it stated that it's a safe and profitable investment and a seasonable and predictable block of business, well, any insurance company in its right mind --

QUESTION: But, surely you're paying money for something. Colonial Life paid out to transport cash and it got in return something it wanted.

MS. CHIECHI: It got in return the issuance of insurance, and that was the cost of issuing that insurance. Just as the cost of issuing directly written insurance is to pay 50 or 60 percent to sales agents, to pay underwriting costs, medical examination fees, state premium tax, and other costs.

If an indemnity reinsurer wants to do business, it pays -- it normally pays a ceding commission. If a direct writer wants to sell policies very effectively, it normally uses sales agents.

QUESTION: But it's not as if the indemnity -- it's not as if transport were itself an insured in the same way that the policyholder in a single deal is an insured, is it?

MS. CHIECHI: With due respect, transport is as much a policyholder of the reinsurer Colonial as you or I would be policyholders of an insurance contract with an insurance company. There are two insurance relationships when you have indemnity reinsurance.

The separate insurance relationship that the ceding company establishes with its policyholders and then that ceding company becomes a policyholder and buys insurance from a reinsurer.

In contrast, in assumption reinsurance there is one insurance relationship. The buying company acquires the position of the selling company, taking the selling company out of an existing insurance relationship.

And it's because the buying company is buying that relationship that the regulations under Section 817 require that purchase price to be amortized.

QUESTION: What makes it hard to go along with you is you say buys the reinsurance. It buys -- that is to say sells because it's the only purchase transaction I'm aware of in which the purchaser receives money instead of paying money. You're saying they buy insurance by receiving money from the person to whom they're selling it. That's a very strange --

MS. CHIECHI: Well, it's in a sense a price rebate. It's also strange for an individual sales agent to --

QUESTION: It's a price -- I know of no price rebate that is -- that is so extensive that the purchaser gets money when he goes in. I don't know. You make up the loss on volume, I --

(Laughter.)

MS. CHIECHI: The Commissioner's counsel suggests repeatedly that there needs to be some specific provision to allow the deduction which we seek here. He's got it backwards.

It is quite clear in the legislative history in the Senate Finance Report dealing with the modified coinsurance that Congress intended that an indemnity reinsurer be treated in substantially the same tax position that it would have been treated if it had issued directly the underlying policy or part thereof.

The only way that can be accomplished is if the Petitioner's position here is accepted.

In terms of standard life and NAIC accounting, I'm glad to see that the Commissioner has backed off his position that accrual accounting rules apply in this case because he must have done that having said that this is not an accounting question.

Well, what Section 818(a) addresses is computations entering into the calculation of taxable income of an insurance company, and if the rules of accrual accounting do not apply, then NAIC accounting is to apply.

Thank you.

CHIEF JUSTICE REHNQUIST: Thank you, Ms. Chiechi.

The case is submitted.

(Whereupon, at 11:57 o'clock a.m., the case in the above-entitled matter was submitted.)

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No. 88-396

COLONIAL LIFE INSURANCE COMPANY, Petitioner, v. COMMISSIONER OF INTERNAL REVENUE

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BY alan friedman

(REPORTER)