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In this article, Geraghty, Greenberg, and Wei address the tax treatment of indemnification payments made under a representation and warranty insurance policy and the costs for acquiring that insurance.

I. Tax Treatment of Indemnification Payments

A taxpayer may take a deduction for any loss sustained during the tax year and not compensated for by insurance or otherwise.[1] If the taxpayer has insurance and receives compensation in the form of insurance proceeds, the insured realizes any gain or loss (measured by the difference between the amount of insurance proceeds and the insured's basis in the property converted) but may avoid recognizing the realized gain to the extent that the insurance proceeds are used to purchase replacement property.[2] In that case, the insured takes a transferred basis in the replacement property and defers gain on the amount by which the replacement cost exceeds the insured's basis in the original property.[3]

But when insurance proceeds do not compensate for injury to property, the proceeds generally constitute income to the insured.[4] In the case of rep and warranty (R&W) insurance, treatment will often be tax neutral, because the insured will frequently be permitted a deduction for the loss triggering payout under the R&W policy. This matching, however, may not always be available — for instance, if the loss is not immediately deductible or is nondeductible.

In the case of federal income tax indemnification payments, for instance, the indemnitee has suffered an economic loss (that is, additional federal income tax liability) for which the indemnitee is unable to take a federal income tax deduction. Significant precedent exists for treating indemnification payments in these circumstances as the nontaxable recovery of

[1] Section 165(a); *see also* reg. section 1.165-1(d)(2) (providing that no deduction for a casualty loss will be recognized to the extent that there is a reasonable prospect of recovery); and reg. section 1.111-1(a)(2) (elaborating on what constitutes a recovery for purposes of the tax benefit rule). The Tax Cuts and Jobs Act suspends the deduction for personal casualty losses for tax years 2018 through 2025.

[2] Section 1033(a)(2)(A).

[3] Section 1033(b)(2).

[4] *Cf.* reg. section 1.1033(a)-2(c)(8) ("The proceeds of a use and occupancy insurance contract, which by its terms insured against actual loss sustained of net profits in the business, are not proceeds of an involuntary conversion but are income in the same manner that the profits for which they are substituted would have been.").

capital.[5] But the IRS interprets these authorities restrictively.[6] Numerous private letter rulings, for instance, have ruled tax indemnification payments are income to the indemnitee. These private letter rulings potentially pose a problem for insureds receiving tax indemnification or other payments under an insurance policy for which the underlying loss is nondeductible. However, given that these private letter rulings deal with professional malpractice (for example, attorney or accounting firm malpractice), one could argue that they are inapplicable to an acquisition transaction and especially in the R&W insurance context.

A. Purchase Price Adjustments

A long line of authority recognizes that indemnification payments made regarding business acquisitions can constitute purchase price adjustments.[7] For stock acquisitions this characterization has sometimes been justified on the ground that indemnification payments, if made by the seller, are nontaxable contributions to capital, which increases the seller's basis in the stock sold.[8] The more generally applicable rationale, however, is that the initial purchase price is simply an estimate of the purchased property's value and that subsequent indemnification payments are adjustments to conform the final purchase price to what the parties later learn is the property's true value.[9]

Most authorities treating indemnification payments made in the business acquisition context as purchase price adjustments involve payments by the buyer to the seller or by the seller to the buyer.[10] Authority also exists, however, for treating indemnification payments made by third parties as purchase price adjustments.[11]

In *Freedom Newspapers*,[12] a taxpayer purchased four newspaper companies. The taxpayer wanted to purchase only three of the newspapers, but the seller insisted that the taxpayer buy the entire group. To induce the taxpayer to consummate the transaction, the seller's brokers entered into an agreement with the taxpayer: The taxpayer agreed to buy the unwanted fourth newspaper, and in return the brokers agreed to resell that newspaper and indemnify the taxpayer $100,000 if they were unable to do so within a specified time and on satisfactory terms.[13] The taxpayer bought all four newspapers and the brokers, who were unable to resell the unwanted newspaper as agreed, paid the taxpayer $100,000.

The Tax Court held that the $100,000 was a purchase price adjustment reducing both the taxpayer's basis in the unwanted newspaper and the loss incurred upon the taxpayer's subsequent sale of that newspaper. The court's rationale was twofold: (1) the indemnification agreement with the seller's brokers was intended to induce the taxpayer to purchase the unwanted newspaper, so both that agreement and the purchase agreement were part of the same transaction and the payments made under both agreements had to be evaluated together;[14] and (2) the $100,000 indemnification payment made by the brokers related back to the sale of the newspapers and so constituted a reduction in the purchase price.[15]

When a purchase agreement makes the purchase of an R&W policy a condition to closing, it seems that *Freedom Newspapers* should govern the tax treatment of indemnification payments

[5] *Clark v. Commissioner*, 40 B.T.A. 333 (1939), *acq.*, 1957-1 C.B. 4; Rev. Rul. 57-47, 1957-1 C.B. 23.

[6] *See, e.g.*, LTR 9833007; LTR 9743035; LTR 9743034; LTR 9728052; and LTR 9226033.

[7] *See, e.g.*, *Freedom Newspapers v. Commissioner*, T.C. Memo. 1977-429 (1977); *Federal Bulk Carriers Inc. v. Commissioner*, 66 T.C. 283 (1976), *aff'd on other grounds*, 558 F.2d 128 (1977); Rev. Rul. 83-73, 1983-1 C.B. 84; Rev. Rul. 58-374, 1958-2 C.B. 396; FSA 199942025; and TAM 7826010.

[8] *See* Rev. Rul. 83-73.

[9] *See* TAM 7826010.

[10] *See, e.g.*, *Federal Bulk Carriers*, 66 T.C. 283; Rev. Rul. 83-73; Rev. Rul. 58-374; FSA 199942025; and TAM 7826010.

[11] *See Freedom Newspapers*, T.C. Memo. 1977-429. A significant number of authorities have also applied purchase price adjustment treatment to other types of third-party payments. *See, e.g.*, Rev. Rul. 88-95, 1988-2 C.B. 28 (inventory protection payments made by the federal government to purchasers of raw cotton); Rev. Rul. 76-96, 1976-1 C.B. 23 (rebates paid by automobile manufacturers directly to qualifying retail customers); and Rev. Rul. 73-559, 1973-2 C.B. 299 ("market discount" and "price differential" payments made by GinnieMae to FannieMae for FannieMae's acquisition of mortgages).

[12] *Freedom Newspapers*, T.C. Memo. 1977-429.

[13] The seller had made the brokers' commission, anticipated to be in the range of a million dollars, contingent on their selling all the newspaper companies.

[14] *See Brown v. Commissioner*, 10 B.T.A. 1036 (1928) (discussing the inducement rationale).

[15] *See Arrowsmith v. Commissioner*, 344 U.S. 6 (1952) (discussing the relation back rationale) and its progeny.

made in accordance with an R&W policy. In those cases, the R&W policy can be considered an "inducement" to the insured to enter into the larger transaction and any indemnification payments can be considered to "relate back" to the original purchase. The IRS has frequently pushed back against taxpayer attempts to apply *Freedom Newspapers* to their own cases or to expand the reach of its reasoning.[16] The R&W insurance scenario, however, is much closer factually to *Freedom Newspapers* than many other cases, because the securing of R&W insurance coverage materially affects the terms of the purchase agreement to which it relates. Absent such coverage, the transaction would either not take place or would take place on significantly different terms, subject to escrows, holdbacks, and other mechanisms for post-closing price adjustments.

In the R&W insurance context, moreover, a plausible legal fiction exists for treating indemnification payments as being made directly by the buyer to the seller or by the seller to the buyer. Indemnification payments made by the insurer to the insured can be recharacterized as payments made first by the insurer to the counterparty in the business acquisition and then from the counterparty to the insured. Such a recharacterization should be tax neutral to the counterparty, because the counterparty will be able to offset any income (or basis adjustment) from the deemed receipt of the insurance proceeds with the expense (or basis adjustment) from the deemed payment to the insured. Such a recharacterization should also be tax neutral to the insured. If the insured is the seller, it will be able to reduce its recognized gain by the amount received. If the insured is the buyer, it will be able to avoid a current income inclusion in exchange for a reduction in basis.

II. Tax Treatment of Insurance Costs

Regardless of who buys the R&W insurance, the costs of the policy probably will have to be capitalized. First, prepaid expenses, including insurance costs, are required to be capitalized.[17] While there is an exception to capitalization when the insurance coverage does not extend beyond the earlier of (1) 12 months after the date on which coverage begins or (2) the end of the tax year following the tax year in which the payment is made,[18] it seems unlikely that the exception would apply in the case of R&W insurance, when coverage typically lasts three to six years. Second, amounts paid to facilitate the acquisition of intangibles,[19] assets constituting a trade or business,[20] and an ownership interest in a business entity are required to be capitalized.[21] R&W insurance costs should often fall into this category. Insureds frequently begin the process of acquiring R&W insurance before closing, and it is not uncommon for acquisition agreements to make the purchase of R&W insurance coverage a condition to closing.

A. Separate Asset

Treasury regulations define a "separate and distinct intangible asset" as "a property interest of ascertainable and measurable value in money's worth that is subject to protection under applicable state, federal or foreign law and the possession and control of which is intrinsically capable of being sold, transferred or pledged (ignoring any restrictions imposed on assignability) separate and apart from a trade or business."[22] R&W insurance satisfies the first part of this definition: It is a property interest of ascertainable and measurable value in money's worth that is subject to legal protection. R&W insurance would also seem to satisfy the second part of the definition: The possession and control of such insurance would appear to be intrinsically capable of being sold, transferred, or pledged apart from the trade or business that is being insured, although there is no direct authority on this point as of the date of this publication.

Whether R&W insurance constitutes a separate asset should be of little consequence if the seller is the insured. For regardless of the

[16] *See, e.g.*, LTR 200743003.

[17] Reg. section 1.263(a)-4(d)(3)(ii), Example 1.

[18] *See* reg. section 1.263(a)-4(f)(1), (8), examples 1 and 2.

[19] Reg. section 1.263(a)-4(e)(1)(i).

[20] Reg. section 1.263(a)(5)(a)(1).

[21] Reg. section 1.263(a)(5)(a)(2).

[22] Reg. section 1.263(a)-4(b)(3).

matter, the seller should be able to realize immediate tax benefits, either because the insurance costs increase the seller's basis in the business being sold or, if the insurance is considered to create a separate capital asset, because the separate capital asset is disposed of in the sale of the business.

By contrast, whether an R&W insurance policy constitutes a separate asset makes a real difference if the buyer is the insured, which is commonly the case, since the answer will determine the term over which the buyer will have to amortize the insurance costs. If the R&W policy constitutes a separate asset, the buyer can amortize the costs of the R&W insurance over the policy's term.[23] But if the R&W policy does not constitute a separate asset, the buyer must either amortize the costs over 15 years (in the case of an asset acquisition)[24] or recover the costs only when it sells the acquired business (in the case of a stock acquisition).[25]

The IRS provides an automatic consent procedure for a manufacturer, wholesaler, or retailer of motor vehicles or other durable consumer goods to change to a method of accounting under which prepaid, lump-sum costs paid or incurred to insure multiyear service warranty contracts are amortized over the life of the insurance policy.[26] Such authority is not directly applicable to R&W insurance. It would seem, however, to provide at least some support that an R&W insurance policy should be considered a separate asset and hence that its costs should be amortized over the life of the policy.

III. Conclusion

Indemnification payments made under an R&W insurance policy may sometimes result in income to the insured without an offsetting deduction. In those circumstances, the insured may be able to rely on *Freedom Newspapers* and related authorities to treat indemnification payments as a purchase price adjustment. Purchase price adjustment treatment would appear to be particularly appropriate where the purchase of R&W insurance is a condition to closing.

An insured will generally have to capitalize the costs of an R&W insurance policy. Whether amortization deductions will be available will depend on whether the policy should be considered a separate asset and, if not, whether the underlying business transaction is a stock or asset acquisition. ■

[23] *See* reg. section 1.167(a)-3 ("If an intangible asset is known from experience or other factors to be of use in the business or in the production of income for only a limited period, the length of which can be estimated with reasonable accuracy, such an intangible asset may be the subject of a depreciation allowance."); *see also* LTR 9402004 (merger target which prepaid five years' worth of officers' and directors' liability insurance in connection with the transaction had to amortize the cost of the policy over the policy's five-year life).

[24] In an asset acquisition, the buyer would include the cost of an R&W insurance policy (that is not treated as a separate asset) in goodwill, which is an amortizable section 197 intangible. *See generally* section 197 (providing that goodwill is a section 197 intangible and that an amortizable section 197 intangible is amortizable on a straight line basis over a period of 15 years).

[25] In a stock acquisition, the cost of an R&W insurance policy (that is not treated as a separate asset) would increase the buyer's basis in the acquired stock. Because stock is not amortizable, the buyer would recover the cost of the R&W policy only upon sale of the acquired stock.

[26] *See* Rev. Proc. 2017-30, 2017-18 IRB 1131; Rev. Proc. 97-37, 1997-2 C.B. 455.