Special Reports

IRS Issues Comprehensive Guidance on the Application of Sections 338 and 1060 to Insurance Companies

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On March 8, 2002, the IRS issued a package of proposed regulations dealing with the myriad of issues relating to the application of sections 338 and 1060 to life and property and casualty insurance companies. The regulations, which were necessary after the IRS published final rules applying a deemed assumption reinsurance approach under section 338, are effective when final regulations are adopted. The proposed regulations' package includes guidance under section 197 relating to the insurance contract intangible acquired in a section 338 or 1060 transaction as well the interplay of the assumption reinsurance principles with the corporate acquisition provisions.

Noteworthy in the new package is the addition of rules which specify the amount of assets which are treated as transferred in exchange for the assumption of insurance liabilities when a section 338 election is made. In addition, the proposed rules: (i) attempt to eliminate the possibility that the reinsurer (or the new Target in a section 338 election) will have immediate premium income in excess of its deduction for assumed insurance reserves, i.e., the "negative ceding commission" or "bargain purchase" situation, and (ii) provide guidance on the interplay between sections 848 and 197. These issues were specifically addressed in industry comments. Also addressed by the industry and the proposed regulations is the treatment of increases in acquired insurance reserves after either a section 338 or 1060 acquisition. Finally, in the context of section 338 elections, the proposed regulations provide needed guidance on the election's effect on the special loss discount amount under section 847, the treatment of old Target's net negative capitalization and other DAC amounts under section 848, and when old Target's policyholders surplus account under section 815 is deemed distributed. As indicated below, the approach taken by the IRS is not the approach that was recommended by the insurance industry on some of the issues.[1] The regulations are proposed to be effective to transactions occurring after the adoption of final regulations.

Proposed Rules Apply to All Reinsurance Transactions Except for Mere Reinsurance of Risks

Transactions covered by the proposed regulations include all section 338 elections for insurance companies and section 1060 "applicable asset acquisitions" of an insurance business.[2] Section 338(g) allows a buyer to treat the purchase of a Target corporation's stock as a taxable purchase of the corporation's assets by new Target followed by a termination of the existence of old Target. Section 338(h)(10), which requires a joint election by the buyer and seller, causes the transaction to be treated as a deemed asset sale of old Target's assets to new Target followed in most cases by the deemed section 332 liquidation of old Target into the selling shareholder.[3] Unlike a section 338(g) election, the stock sale is disregarded in a section 338(h)(10) joint election. In either case, there is no actual reinsurance transaction between the old Target and new Target.

Under section 1060, an acquisition is an "applicable asset acquisition" of an insurance business if the purchaser acquires significant business assets, in addition to the reinsurance of insurance contracts, to which goodwill and going concern value could attach.[4] Both assumption reinsurance and indemnity reinsurance can be applicable asset acquisitions if the reinsurance is accompanied by the acquisition of

[1]The comments from the property and casualty insurance industry included a letter on behalf of Alliance of American Insurers, American Insurance Association, National Association of Independent Insurers, National Association of Mutual Insurance Companies, and Reinsurance Association of America, July 20, 2000 (*Doc. 2000-20025; 2000 TNT 145-16*); a letter from Mark H. Kovey, Insurers Want Purchase Price Allocation Regs. Clarified, *The Insurance Tax Review*, September 2002, p. 507. The comments from the life insurance industry included a letter from the American Council of Life Insurance, July 20, 2000 (*Doc. 2000-21364; 2000 TNT 159-16*).

[2]The proposed rules apply to all forms of insurance companies The Preamble notes that "the general structure of the [Treas. Reg. section 1.817-4(d)] regulations is not based on any statutory provisions unique to life insurance companies."

[3]The deemed section 332 liquidation of old Target is generally subject to section 381. The section 332-381 complete liquidation concept does not apply to section 338(g) elections.

[4]Prop. Treas. Reg. section 1.1060-1(b)(9).

significant business assets.[5] The proposed regulations also provide that the mere reinsurance of contracts is not an applicable asset acquisition subject to the proposed rules even if it enables the reinsurer to establish a customer relationship with the policyholders.

The determination of when an acquisition constitutes an applicable asset acquisition might be difficult to make in various situations, such as certain indemnity reinsurance transactions, without the benefit of further guidance. FSA 200144028 (Nov. 2, 2001) provides guidance on the extreme case favoring the application of section 1060. Under the facts presented in the FSA, the ceding company transferred the insurance liabilities to the reinsurer under an 100% indemnity reinsurance agreement. The assuming company also acquired all the assets associated with the line of business, including investment assets, surplus, agency force, underwriting personnel, computers, software and its licenses pursuant to several other agreements. The ceding company granted a covenant not to compete for a certain period of years. Under these facts, where there are a number of assets which could be construed as significant business assets, it is relatively clear that there is an applicable asset acquisition.

However, absent such an extreme case, the proposed regulations provide little guidance. Questions can be raised as to what will constitute "significant business assets . . . to which goodwill and going concern value could attach." Although the terms goodwill and going concern value are defined for section 1060 purposes, the section 1060 guidance offers little instruction for insurance business scenarios.[6] Depending on the overall facts, it would seem that significant business assets would include the various staffs involved with insurance, such as the distribution or marketing groups, underwriting, adjusters or claim operations, investments, human resources and management, as well as the tools of such groups, including computers, software, customer relationships, office or equipment leases and so forth.

Assumption Reinsurance Rules Apply With Cap on Income to Assuming Company

Under the proposed regulations, Target's closing tax reserves will be treated as fixed, not contingent, liabilities in determining seller's ADSP (used to determine the amount of gain or loss on a deemed sale of reinsurer's or old Target's assets) and buyer's AGUB (used to determine basis of the assuming company's or new Target's assets, including section 197 intangibles). The residual method currently used in sections 338 and 1060 will apply to allocate the ADSP and AGUB among all classes of transferred assets, including the insurance contracts (the term used in the proposed regulations to refer to the ceding commission or insurance in force). The residual method allocation will be applied before applying the assumption reinsurance principles for determining the tax consequences.

Under existing Treas. Reg. section 1.817-4(d)(2), a reinsurer is required to recognize premium income in excess of its deduction for the increase in tax reserves where the actual assets transferred to the reinsurer exceed the tax reserves. The existing regulations also treat the reinsurer as receiving premium income equal to the deduction taken for tax reserves in those cases where the actual assets transferred are less than the tax reserves.[7] The proposed regulations do not amend the application of these existing assumption reinsurance regulations to reinsurance transactions which do not constitute applicable asset acquisitions or result from section 338 elections.[8] However, certain modifications to these principles are made in applying the regulations to sections 338 and 1060 reinsurance transactions.

Under the proposed (and existing) regulations, the ceding company is treated as recognizing income equal to the reduction in its tax reserves and is entitled to a deduction for the gross premium it transfers to the reinsurer for the assumption of the insurance liabilities less the ceding commission it receives. However, under the proposed regulations, to prevent immediate premium income to the reinsurer (or new Target), the gross amount of the reinsurance premium paid by the ceding company (or old Target) to the assuming company will be deemed *equal* to the ceding company's closing tax reserves in all cases.[9] Consequently, as long as the reinsurer's deduction for the acquired tax reserves equals the ceding company's tax reserves, the reinsurer cannot have gross premium income in excess of its reserve deduction. Although not stated as a "cap," the rule ordinarily works as a cap because neither party can be treated as transferring or receiving consideration for reinsurance that exceeds the ceding company's transferred tax reserves.

Furthermore, the proposed regulations provide that the amount of the ceding commission received by the ceding company and paid by the reinsurer is the amount allocated to the insurance contracts under the ADSP and AGUB residual formulas applied generally under the existing section 338 regulations. In order to determine the amount allocable to the insurance contracts, Prop. Treas. Reg. section 1.338-11(b)(2) provides that the fair market value of the in-

[5] Under Prop. Treas. Reg. section 1.197-2(g)(5)(i)(B), an assumption reinsurance transaction is defined as "an arrangement whereby the reinsurer becomes solely liable to the policyholders on insurance contracts transferred by the ceding company." This is essentially the same definition of assumption reinsurance as is contained in current Treas. Reg. section 1.809-5(a)(7)(ii).

[6] *See* Treas. Reg. section 1.1060-1(b)(2)(ii). It is not clear if related transactions will be taken into account to determine if there has been a "transfer" of significant business assets in the context of reinsurance transactions. *See* Treas. Reg. section 1.1060-1(b)(5).

[7] Treas. Reg. section 1.817-4(d)(2)(iii).

[8] The package of proposed regulations does not comment on why no changes are made to the Treas. Reg. section 1.817-4(d) provisions, and are silent as to whether changes in the future will be proposed. The lack of consistency between situations subject to sections 338 or 1060 and those subject only to Treas. Reg. section 1.817-4(d) places great stress on determining when there is a transfer of "significant business assets."

[9] Prop. Treas. Reg. section 1.338-11(b)(2).

surance contracts is the amount a willing reinsurer would pay a willing ceding company in an arm's length transaction as a ceding commission for the reinsurance of specific insurance contracts if the gross reinsurance premium for the insurance contracts were equal to the ceding company's tax reserves for the insurance contracts.[10]

FIGURE A

1.338-11(c)(4)

Ex. 1 = Positive Ceding Commission

FACTS

Pre-Election Assets and Liabs.		After Election, Allocation of ADSP + AGUB
Cash	10	10 Class I
Securities	30	30 Class II
Equip.	10	10 Class V
Life Ins. K.*	17	16 Class VI
Goodwill, etc.	-	0 Class VII
Reserves	50	
Other Liabs	0	
....		
Purch. Price	16	
DAC Gen'l Deds.**	20	

ANALYSIS

ADSP (16+50)=66
AGUB (16+50)=66

Deemed Assumption Reinsurance:
Old T 50 (decrease in reserves)
Old T (34) (50-16, reserve increase minus deemed ceding comm'n)
Old T 34 (net neg. consid. under section 848)

New T 50 (prem. income)
New T (50) (reserve deduction)
New T 34 (net pos. consid. under section 848)

New T (2.62) (capitalized and amortized under section 848 (34 x 7.7%))
New T(13.38) (16-2.62) (amortizable under section 197(f)(5), and basis in K)
New T (17.38) (20-2.62) (deductible general deductions)
New T (2.62) (section 848(g) deductible portion of ceding commission)

*Life insurance contract valued with limitation on value as if maximum gross reinsurance premium is old T's tax reserves.

**Not including any portion of the ceding commission in the deemed assumption reinsurance.

The net effect of the cap under the proposed regulations is that reinsurer (or new Target) will not have immediate premium income.[11] If the reinsurer had premium income, there would have been additional basis equal to such income to assign to the acquired insurance contracts. Most taxpayers should find this an acceptable trade-off. The impact of the cap can be seen in the two examples in the proposed regulations, one assuming a positive ceding commission and the other a "negative" ceding commission. [See Figures A & B.] Example 2 illustrates that there can be no "negative" ceding commission under the proposed regulations because

FIGURE B

1.338-11(c)(4)

Ex. 2 = Negative Ceding Commission (Capped at Zero Value)

Pre-Election Assets and Liabs.		After Election, Allocation of ADSP + AGUB
Cash	10	10 Class I
Securities	30	30 Class II
Equip.	10	10 Class V
Life Ins. K.*	0	0 Class VI
Goodwill, etc.	-	16 Class VII
Reserves	50	
Other Liabs	0	
....		
Purch. Price	16	
DAC Gen'l Deds.**	20	

ANALYSIS

ADSP=(16+50)=66
AGUB=(16+50)=66

Deemed Assumption Reinsurance:
Old T 50 (decrease in reserves)
Old T (50) (50-0) (reserve increase minus deemed ceding comm'n)
Old T 50 (net. neg. consid under section 848)

New T 50 (prem. income)
New T (50) (reserve deduction)
New T 50 (net pos. consid. under section 848)
New T (3.85) (capitalized and amortized DAC (50 x 7.7%))
New T 0 (amortizable under section 197(f)(5), and basis in K)
New T (16.15) (20-3.85) (deductible general deductions)

*Life insurance contract valued with limitation on value as if maximum gross reinsurance premium is old T's tax reserves.

**Not including any portion of the ceding commission in the deemed assumption reinsurance.

[10] Prop. Treas. Reg. section 1.338-11(c)(3) provides that the ceding commission is deemed to be the amount equal to the amount allocated to the insurance contracts under the existing Treas. Reg. section 1.338-6 and -7, as modified by Prop. Treas. Reg. section 1.338-11(b). The latter provision provides that the fair market value of the insurance contracts, for purposes of allocating ADSP and AGUB, will be treated as the amount paid in an arm's length transaction for the reinsurance of the acquired contracts if the gross reinsurance premium for the contracts were equal to old Target's tax reserves for the contracts.

[11] See discussion below regarding section 846(e) and other situations where new and old Target may have different tax reserves for the acquired insurance contracts.

the determination of the value of the acquired contracts under the ADSP and AGUB regime can never produce a value less than zero. That is, a negative ceding commission can only occur if the gross reinsurance premium exceeds the acquired tax reserves which is not expected to occur under the proposed regulations. (However, this can still occur in mere reinsurance transactions not covered by the proposed rules or in situations where the assuming company's acquired tax reserves are less than the ceding company's transferred tax reserves). Where there is a deemed ceding commission of zero, no basis is assigned to the acquired insurance contracts in the hands of the reinsurer.

Certain Post-Transaction Reserve Deductions Must Be Capitalized

Traditionally, an insurance company determines the appropriate reserves for the business it writes or reinsures, taking into account the requirements of its state insurance regulators and its own considerations, such as its own risk guidelines and surplus capacity. Especially in the property and casualty field, the unpaid loss reserve is an estimate that may be updated frequently based on increasing knowledge gained about the claim and other factors.[12] Therefore, it is common for the reinsurer to reassess the reserves after assuming the liability. The proposed regulations generally do not respect this practice and will require the reinsurer to capitalize many customary reserve increases following the section 338 or 1060 reinsurance transaction.

The proposed regulations require capitalization for increases to unpaid loss reserves on acquired insurance con-

FIGURE C

1.338-11(d)(7)

Ex. 1

No Adjustment for Increase in Unpaid Loss Reserves

FACTS

Purch. Price	120		
Assets (I-V)	700		
Assets (VI)	75		
Total Stat. Reserves 1/1/03	725	Total Tax Reserves 1/1/03	580
Unearned Prems.	100	Unearned Prems.	80 (after "haircut")
Unpaid Losses	625	Unpaid Losses	500 (after discount)

LAE in 2003 = 200

12/31/03 Unpaid Losses
Stat. 435
Tax 360

ANALYSIS

AGUB 700 (120 + 580)
700 (Assigned to Assets (I-V))
0 (Assigned to Assets (VI))
A/B x (C - [D + E])=formula
A = 500
B = 625
C = 435
D = 437.50 [(625 x 1.02) - 200]
E = 0
500/625 x (435 - [437.50 + 0]) = 0
No adjustment for 2003 because new T's end of year stat. unpaid stat. losses (435) do not exceed 437.50 (D + E), which is the old T's stat. beginning of year unpaid losses adjusted by 1.02 (625 x 1.02) reduced by loss payments and expenses (200).

FIGURE D

1.338-11(d)(7)

Ex. 2

Adjustment for Increase in Unpaid Loss Reserves

FACTS

Purch. Price	120		
Assets (I-V)	700		
Assets (VI)	75		
Total Stat. Reserves 1/1/03	725	Total Tax Reserves 1/1/03	580
Unearned Prems.	100	Unearned Prems.	80 (after "haircut")
Unpaid Losses	625	Unpaid Losses	500 (after discount)

LAE in 2003 = 200
LAE in 2004 = 375
12/31/04 Unpaid Losses
Stat. 150
Tax 125

ANALYSIS

AGUB 700 (120 + 580)
700 (Assigned to Assets (I-V))
0 (Assigned to Assets (VI))
A/B x (C-[D+E])=formula
A = 500
B = 625
C = 150
D = 75 [(625 x 1.04) - 575]
E = 0
500/625 x (150 - [75 + 0]) = 60

An adjustment of 60 for 2004 is required. The 60 additional premium income offsets the increase in unpaid loss reserve deductions taken by new T; also AGUB for the acquired insurance contracts in Class VI is increased by 60. See section 197(f)(5) for treatment of the 60.

[12]The insurance company is required to establish its unpaid loss reserves "in amounts which, based upon the facts in each case and the company's experience with similar cases, represent a fair and reasonable estimate of the amount the company will be required to pay." Treas. Reg. section 1.832-4(b).

tracts which reflect changes in loss estimates in excess of two percent annually if the reserve is increased within four years of the acquisition. The amount of the reserve increase in excess of the two percent is determined pursuant to a formula provided in Prop. Treas. Reg. section 1.338-11(d)(3). [See Figures C-F.] For reserves other than unpaid loss reserves, the reserve increases must be capitalized if they are attributable to changes in methodology or assumptions used to compute the reserve on acquired contracts, including the use by the reinsurer of a methodology or assumption different than that used by the ceding company.[13]

FIGURE E

1.338-11(d)(7)

Ex. 3

Adjustment for Unpaid Loss Reserve Increases Because of Reinsurance

FACTS

Purch. Price	120		
Assets (I-V)	700		
Assets (VI)	75		
Total Stat. Reserves 1/1/03	725	Total Tax Reserves 1/1/03	580
Unearned Prems.	100	Unearned Prems.	80 (after "haircut")
Unpaid Losses	625	Unpaid Losses	500 (after discount)

LAE in 2003 = 200
LAE in 2004 = 375
LAE in 2005 = 0
Reinsurance of all remaining liability on 1/01/05
Reins. Premium Paid = 175
12/31/05 Unpaid Losses
Stat 0
Tax 0

ANALYSIS

AGUB 700 (120 + 580)
700 (Assigned to Assets (I-V))
0 (Assigned to Assets (VI))
A = 500
B = 625
C = 0
D = (87.50), [(625 x 1.06) - (575 + 175)]
E = 75
A/B x (C - [D + E]) = formula
(500/625) x (0 - [-87.50 + 75])=10

An adjustment of 10 for 2005 is required. 10 is included in premium income to offset prior increases to the unpaid loss reserve; also 10 is added to AGUB for the acquired insurance contracts for 2005. See section 197(f)(5) for treatment of the 10.

There are two exceptions to these rules. First, capitalization is not required to the extent the deduction for the reserve increase for a life company is spread over 10 years under section 807(f). Second, capitalization is not required for post-acquisition increases in reserves while the insurer is under a state receivership proceeding.[14] Outside these exceptions, the capitalization is applied automatically and there is no opportunity for the taxpayer to demonstrate that the reserve in fact was not "understated" by the ceding company or that the increase in reserves is based on non-tax factors.

When capitalization is required, the reinsurer must include an amount in gross income to offset the increase in reserve deduction and include the same amount in AGUB. The ceding company will not make any adjustments. The adjustments will be detrimental to the reinsurer in many situations because it will replace an immediate tax deduction with an additional section 197 amortization deduction (usually over 15 years). Taxpayers are directed to treat the increase in AGUB as another AGUB redetermination event under Treas. Reg. sections 1.338-5(b)(ii) and 1.338-7. Those provisions provide detailed guidance on allocating redetermined AGUB, even with respect to assets that have been disposed of by the reinsurer before the redetermination is made.

In some cases, the additional capitalization that increases the AGUB might result in an increase to the amount of AGUB allocable to the acquired insurance contracts.[15] Once allocated to the insurance contracts, the additional

FIGURE F

Formula for determining when unpaid loss reserve increases result in premium income to offset the reserve deduction.

A/B x c - [D + E]) where
A = Old T's tax unpaid loss reserves included in AGUB.
B = Old T's stat. unpaid loss reserves included in AGUB.
C = New T's stat. unpaid loss reserves at end of year re Old T's losses incurred by Old T on/before the acquisition.
D = (may be negative)
Multiply Old T's stat. unpaid loss reserves by 1.02, 1.04, 1.06 or 1.08 by 1-4 years.
Subtract the cumulative amount of losses, LAE and reins. premiums paid by New T re Old T's losses incurred on/before the acquisition.
E = cumulative amount of stat. reserves taken into account by New T as adjustments to unpaid loss reserves re Old T's losses incurred on/before the acquisition.

Prop. Treas. Reg. section 1.338-11(d)(3).

[13]Prop. Treas. Reg. section 1.338-11(d)(4). There is no two percent exception for reserves other than unpaid loss reserves.

[14]Prop. Treas. Reg. section 1.338-11(d)(2).

[15]*See* Prop. Treas. Reg. section 1.338-11(d)(1), (7) ex. 2(ii).

FIGURE G

TREATMENT OF CEDING COMMISSION

	DAC Contracts	Non-DAC Contracts
Assumption Reinsurance	Section 197 - 15 year amortization and Section 848 - 10 year amortization	Section 197 - 15 year amortization
Indemnity Reinsurance	Section 848 - 10 year amortization and immediate deduction under Section 848(g)	*Colonial American* amortization

amount should be treated in whatever way it would have been treated if initially assigned to the insurance contracts. Thus, if the reinsurance transaction that precedes the tainted reserve increase is assumption reinsurance (either under section 338 or 1060), the additional amount could be taken into account under section 197(f)(5) to determine both the portion of the ceding commission that is subject to section 848 and any remaining portion that is subject to the 15-year amortization rules of section 197. The additional amount that increases AGUB can only increase the amount allocable to the insurance contracts if the amount of AGUB previously allocated to the insurance contracts was less than its fair market value as determined under the proposed regulations.[16] Presumably, if the initial reinsurance was an indemnity reinsurance transaction of DAC contracts and an applicable asset acquisition under section 1060, any additional AGUB allocated to the acquired insurance contracts should be fully deductible either as additional DAC or as a result of section 848(g). Under that section, a ceding commission on a reinsurance transaction involving DAC contracts is immediately deductible, except as required by section 197 and section 848. As a result, when the transaction is indemnity reinsurance of DAC contracts (which therefore is not subject to section 197), the additional AGUB amount allocated to the ceding commission should be fully deductible.[17]

A more common scenario is anticipated by the proposed regulations. A likely situation that might lead to a post-transaction reserve increase is when the value of the insurance contracts is zero.[18] If the insurance contracts have a zero value, the AGUB rules do not allow the allocation of any basis to the insurance contracts under Treas. Reg. section 1.338-6(c). Consequently, the allocation of the additional AGUB from the capitalization will not be assigned to the insurance contracts (i.e., the ceding commission) but, depending on the assets subject to the AGUB rules, may be assigned to other section 197 intangibles deductible over 15 years.

The reserve adjustment rules should be both clarified and limited so that capitalization is not mandated when the parties have not undertaken tax abusive transactions. Under the proposed regulations, post-acquisition reserve increases must be capitalized in certain situations where the ceding company's tax reserves as of the acquisition date were understated.[19] The stated purpose of this required capitalization is to avoid reserve increases after the acquisition which produce a better result than if the ceding company increased them before the acquisition. These statements color post-transaction reserve increases as inappropriate because, according to the Preamble, "courts have held that when contingent liabilities assumed in connection with an asset acquisition mature, such liabilities must be capitalized as a cost of the acquired assets, even if those matured liabilities would have been currently deductible had they been incurred in the acquirer's own historic business."[20] Notwithstanding this "spin" comparing reserve increases to contingent liabilities, the Preamble also acknowledges that "adjustments to [reserve] estimates are customary."

It is questionable why such a stringent rule is needed since most reserve strengthening is caused by regulatory or economic imperatives. It is not persuasive to cite to the treatment of other taxpayers' contingent liabilities since reserve adjustments are customary for insurers and the Preamble acknowledges that insurance reserves should not be treated as contingent liabilities in determining ADSP and AGUB for insurance companies because they are inherently different from other types of liabilities. It is likely that the limits on post-acquisition reserve increases will be the most controversial portion of the proposed regulations.

Section 815 PSA Will Be Triggered Generally

Under section 815, a life insurance company which has an existing "policyholders surplus account" ("PSA") can be deemed to have taxable income if it makes a direct or indirect distribution to its shareholders in excess of its "shareholder surplus account" ("SSA"). The concept of a PSA, created in the 1959 Act, essentially represents a deferred tax liability that is triggered upon distributions to shareholders or other events referenced in section 815(f). Included as a triggering event in former section 815(d)(2) is the company ceasing to qualify as a life insurance company when the in-

[16] *See* Prop. Treas. Reg. section 1.338-11(d)(5); Treas. Reg. section 1.338-6(c).

[17] *See* discussion of interplay of DAC and section 197 below.

[18] *See* Prop. Treas. Reg. section 1.338-11(d)(7), ex. 2.

[19] *See* Preamble to Prop. Treas. Reg. section 1.338-11. The IRS addressed the reserve strengthening issue in FSA 200018003 (May 5, 2000) and FSA 1998-476 (Aug. 31, 1998), where the National Office advised that deductions resulting from the strengthening of unpaid loss reserves were appropriate after a taxable acquisition of a nonlife insurance business.

[20] After the quoted language, the Preamble cites to *Pacific Transport Co. v. Commissioner*, 483 F.2d 209 (9th Cir. 1973).

surance business is not transferred to a shareholder life insurance company pursuant to section 381(c)(22).

In general, when a life insurance company's stock is sold pursuant to a section 338(g) election (and, therefore, the selling shareholder is taxed on the sale of Target stock), an amount will be treated as a distribution under section 815 under the proposed regulations. The Preamble explains that the selling shareholder has received value for the stock in a transaction not subject to section 381, and that value should be considered an indirect distribution out of section 815 accounts.

The distribution generally will equal the grossed-up purchase price of Target's stock (as if 100% of the stock was purchased during the one-year acquisition period). If the purchase price exceeds the SSA, any amount in excess of the SSA will be taken into income as a distribution out of the PSA. However, to the extent that the purchase price does not exceed the combination of the SSA and all of the PSA, any remaining PSA is not triggered and appears to go untaxed. Since old Target's SSA will be increased by reason of any taxable gain to old Target in its deemed asset sale before determining if (and how much of) the SSA and PSA are reduced, there will be some transactions where the proposed regulations forgive part of the PSA.

A similar deemed distribution under section 815 may apply when section 338(h)(10) is elected. On the other hand, if 50 percent or more of old Target's insurance business is in fact transferred to Target's selling life insurance company shareholder in a section 338(h)(10) transaction, the PSA and SSA will carryover to the shareholder in full without any deemed distribution. This is because the transfer of assets to Target's shareholder generally will be treated as distributed pursuant to a tax-free liquidation under section 332 with attribute carryover under section 381. Under the proposed regulations, the section 381(c)(22) exception to the triggering of the PSA will, in effect, apply when the 50 percent test is satisfied. When less than 50 percent of the insurance reserves are actually transferred to Target's shareholder, the shareholder will succeed to only a pro rata portion of the section 815 accounts, based on a ratio of the transferred reserves to total reserves. With respect to the remaining section 815 accounts, there will be a deemed distribution equal to the grossed-up purchase price of the Target's stock. Therefore, there will be a taxable distribution from old Target's PSA if the grossed-up amount exceeds the balance in the SSA (as determined after the deemed sale of old Target's assets in the section 338(h)(10) transaction).

The Preamble attempts to justify these rules, which differ substantially from what was requested by the life insurance industry, on the basis that "when old target's PSA is separated from old target's insurance business, the purposes of the PSA [to meet future policyholders' claims] are not served by further deferral." Whatever the merits of that view, it departs from the general view of applying section 815. Traditionally, the government took the position that the section 815 account balances carryover in full in a transaction subject to section 381(a).[21] No distinction previously has been made as to what percentage of the assets, business or historic policyholders are subject to the transfer to the party inheriting the tax attributes under section 381 as long as the transfer qualified as a complete liquidation or reorganization under section 381(a) and the transferee was an insurer eligible for such carryovers under section 381(c). The proposed regulations depart from this time honored position and apply a specialized form of business continuity requirement to force a triggering of the PSA into taxable income. Nor is there any support for the Preamble's assertion that the "separation of old target's PSA from old target's insurance business effects a distribution."[22] Finally, the 50 percent test as to when the carryovers are limited is inconsistent with section 381 which imposes no such test.[23]

Section 847 Estimated Tax Payments on Unpaid Losses Will Disappear

Section 847 provides special rules whereby an insurance company is entitled to an additional deduction related to the amount of undiscounted unpaid losses if the company makes a special estimated tax payment. The special estimated tax payment is intended to cause the additional deduction to have a revenue-neutral effect because the tax paid is as if the additional deduction was not permitted. Section 847(6) provides rules in the case of a liquidation or termination of a taxpayer's insurance business after a special estimated tax payment.

The deemed asset sale under section 338 by old Target will cause its special loss discount account under section 847(3) to be taken into income under Prop. Treas. Reg. section 1.338-11(g). However, if old Target actually distributes its lines of insurance business to a selling shareholder which is an insurance company, all or a portion of the balance in the special loss discount account is transferred to old Target to the extent that the portion of old Target's special loss discount account is attributable to the insurance business that is transferred to the shareholder.[24] The Preamble notes that old Target may use its special estimated tax payments under section 847 to offset this inclusion of income, but any special estimated tax payments remaining will be voided and disappear.

[21] Section 381(c)(22); Treas. Reg. section 1.381(c)(22)- 1(b)(7)(i); Rev. Rul. 77-248, 1977-2 C.B. 228.

[22] The citation in the Preamble to Rev. Rul. 95-19, 1995-1 C.B. 143, is inapposite since that ruling treated a distribution to a party other than the acquiring company under section 381(c) as a section 815 distribution.

[23] Such a novel and difficult position may become ammunition for those members of Congress who believe that section 815 and the PSA account balances should be rescinded because the provision has become unworkable and a hindrance to efficient financial operations.

[24] *See* Prop. Treas. Reg. section 1.381(c)(22)-1(b)(14). Although the proposed regulations limit the carryover only to a life insurance company, there is no policy reason not to allow carryover to a property and casualty insurer.

Section 846(e) Election Must Start Anew in a Section 338 Election

Section 846 generally requires an insurance company to compute its unpaid loss reserves on a discounted basis. Section 846(e) provides that an insurance company may make an election to use its own historical payment pattern for purposes of determining its discounted unpaid losses. Consistent with the view that new Target is a different taxpayer from old Target for purposes of Subtitle A, the Preamble notes that new Target will not be permitted to apply old Target's experience as a result of any section 846(e) election.

As a result of the inapplicability of section 846(e), it is possible that old Target's tax reserves will exceed new Target's tax reserves. In that situation, the proposed regulations might be read to require new Target to have immediate premium income in excess of its reserve deduction because the regulations deem new Target to receive reinsurance premium income equal to the amount of *old* Target's tax reserves.[25] In that case, new Target will determine its AGUB by the higher amount of old Target's tax reserves. Thus, new Target will have additional amortization deductions (or an increased immediate deduction under section 848(g) in an indemnity reinsurance transaction involving DAC contracts). Nonetheless, the requirement to base new Target's premium income on old Target's reserves may cause new Target to suffer an immediate tax hit as a result of the deemed premium income rule.[26]

DAC and Section 197 Rules Applied to Sections 338 and 1060 Reinsurance

Section 848 requires the capitalization and amortization of specified policy acquisition expenses based on a proxy of the net premiums received or the net consideration in a reinsurance agreement (known as the "DAC" tax). Consistent with its treatment of the deemed asset sale of Target in a section 338 acquisition as an assumption reinsurance transaction, the proposed regulations prescribe that the deemed asset sale also will be treated as assumption reinsurance for purposes of applying section 848. Thus, the negative capitalization amount that generally results from the ceding company's reinsurance will first reduce its current year's capitalization requirement and then will offset any unamortized DAC that the ceding company capitalized in prior years, which will result in a current expense deduction. The negative capitalization amount will be determined by treating as the "net consideration" in the deemed or actual reinsurance transaction the difference between the ceding company's tax reserves on the block of business transferred and the ceding commission deemed received by the reinsurer.

The proposed regulations limit the carryover of any remaining DAC attributes in a section 338 transaction. For section 338(g) transactions, the DAC attributes do not carryover since there is no deemed section 332-381 liquidation of Target. If the parent company of Target is an insurance company, the DAC attributes will carryover to the parent under section 381(c)(22) on the deemed liquidation of old Target that is generally part of a section 338(h)(10) election.[27] However, if the parent is not an insurance company, any remaining unamortized DAC in old Target will be immediately deductible to old Target; any remaining excess negative capitalization amount in old Target will be eliminated.

Enacted in 1993, section 197 generally provides a 15-year amortization of an intangible acquired in connection with the acquisition of a trade or business. Section 197(f)(5) is a special rule relating to the acquisition of an insurance contract intangible[28] in an assumption reinsurance transaction. It requires that the excess of the amount paid or incurred by the reinsurer over the amount of specified policy acquisition expenses required to be capitalized under section 848 is an intangible asset that must be amortized under the section 197 15-year regime. Section 197(f)(5) is limited to assumption reinsurance transactions, whether a deemed assumption reinsurance transaction under section 338 or one that is an applicable asset acquisition under section 1060. However, section 197(f)(5) is not limited to assumption reinsurance transactions in which the contracts reinsured are specified insurance contracts under section 848. This is demonstrated in Prop. Treas. Reg. section 1.197-2(g)(5)(i)(C)(3) which provides that, when section 338 or 1060 is not involved, the amount paid or incurred by the reinsurer for the acquired insurance contracts is the "excess of the increase in the reinsurer's tax reserves resulting from the transaction (computed in accordance with sections 807, 832(b)(4)(B) and 846) over the value of the net assets received from the ceding company in the transaction."[29] The

[25]It is ironic that a rule (reinsurance premium shall equal tax reserves) designed to prevent immediate premium income by capping the consideration taken into income by the reinsurer to an amount that in most situations will be offset by the reserve increase deduction becomes a rule that will create net income to the reinsurer when its actual reserve increase deduction is less than the reinsurance premium deemed received.

[26]There are other instances when the reinsurer might have lower tax reserves than the ceding company for the same acquired insurance contracts. For example, the reinsurer might want to minimize its statutory reserves on its unpaid loss reserves to conserve surplus. The scenario discussed in the text would be avoided if new Target determined its gross premium received (and AGUB) by reference to its own tax reserves on the contracts reinsured. The proposed regulations (and their examples) seem to assume that there will be consistency on both sides because both parties must determine the tax consequences by reference to old Target's tax reserves. The reality is that the section 338 regulations themselves have rules for determining ADSP and AGUB that rarely result in identical amounts because of the expenses each incurs in the transaction. *See* Treas. Reg. section 1.338-5(c)(3), AGUB determined by including acquisition costs; Treas. Reg. section 1.338-4(c)(iii), ADSP determined by a reduction for selling costs.

[27]As with section 847 attributes, there is no policy reason to limit the carryover when the selling shareholder is a property and casualty insurer, although the proposed regulations do not provide for such carryover. Further, the proposed regulations, at Prop. Treas. Reg. Section 1.381(c)(22)-(b)(13), do not impose a business continuity test, as they do for section 815 and 847 accounts.

[28]The intangible traditionally has been called the ceding commission, insurance in force, etc.

[29]As noted below, there is no cap on the amount of premium income under Treas. Reg. section 1.817-4(d) when a reinsurer acquires an insurance business which is not characterized as either a section 338 acquisition or applicable asset acquisition under section 1060. However, can there be a ceding commission when the reinsurer receives more assets than its reserve deduction?

references to reserves under section 832(b)(4)(B), which is the "haircut" on unearned premium reserves, and the discounting of unpaid loss reserves under section 846, are references to situations that relate principally to non-DAC contracts of property and casualty insurers. For non-DAC transactions, therefore, the basis of the amortizable section 197 intangible acquired in the assumption reinsurance transaction will be the increase in the reinsurer's tax reserves over the value of the net assets received, i.e., the ceding commission. In that case, the full amount of the ceding commission will be subject to 15-year amortization.[30]

The proposed regulations provide rules for determining the amount of the section 197(f)(5) intangible, the section 848 amount and the interaction of sections 197(f)(5) and 848. Unlike section 197, section 848 applies to the transfer of life insurance, noncancellable accident and health insurance contracts, and annuity contracts (i.e., the DAC contracts) pursuant to either assumption or indemnity reinsurance. Section 848(g) makes it clear that a ceding commission paid in an indemnity reinsurance transaction of DAC contracts is immediately deductible. Section 848(g) repealed prior law as to the DAC contracts, which required the capitalization of a ceding commission over the useful life of the acquired contract pursuant to *Colonial American Life Ins. Co. v. Comm'r,* 491 U.S. 244 (1989). In *Colonial American*, the Supreme Court extended the capitalization and amortization in Treas. Reg. section 1.817-4(d) to indemnity reinsurance so that amortization of a ceding commission paid in an indemnity or assumption reinsurance transaction was spread over the term of the reinsurance agreement.

When section 197(f)(5) was enacted in 1993, section 848(g) was kept intact but made subject to section 197. Consequently, when DAC-type contracts are reinsured via assumption reinsurance, any ceding commission in excess of the DAC amount attributable to the reinsured contracts is subject to the 15-year amortization of section 197. But if the DAC contracts are indemnity reinsured, section 197 is inapplicable and section 848(g) provides an immediate deduction for the ceding commission in excess of the DAC amount.[31] Finally, if DAC contracts are not involved in an indemnity reinsurance transaction, then section 848(g) is not applicable and the *Colonial American* considerations apply. [See Figure G]

In order to coordinate the determination of the section 197 intangible (i.e., the ceding commission) with the section 848 calculation, the proposed regulations first provide that the amount required to be capitalized under section 848 for purposes of section 197 is determined by multiplying the reinsurer's specified policy acquisition expenses for the taxable year that includes the transaction by a fraction, the numerator of which is the reinsurer's tentative positive capitalization amount for the relevant acquired insurance contracts and the denominator of which is the reinsurer's total tentative positive capitalization amount for the taxable year with regard to all specified insurance contracts.[32]

Determining the DAC amount could have required a complex, if not circular, calculation because DAC is determined on a taxable year basis and depends on the existence of general expense deductions for the reinsurer whereas the section 197 intangible is a general deduction relevant in computing DAC. The proposed regulations avoid that calculation by assuming, among other things, that, for purposes of computing general deductions (as defined in section 848(c)(2)), one-half of the consideration allocated to the insurance contracts is treated as a section 197 intangible for which an amortization deduction is allowed under section 197(a).[33] The rules applicable to determining the specified policy acquisition expenses, net premiums, and net positive consideration are found in the existing regulations under Treas. Reg. section 1.848-2(a) and (f). Special operating rules have been proposed for purposes of determining the amount of DAC to be capitalized under section 197(f)(5). Thus, the special policy acquisition expenses can never be less than zero; the net premiums for the taxable year cannot be less than the sum of the positive consideration for all con-

[30] Including assumption reinsurance of non-DAC contracts under this provision does not seem to be required by the language in the statute. Section 197(f)(5) arguably could have been read to apply only to assumption reinsurance of DAC contracts because it excludes from 15-year amortization amounts under section 848 but it does not refer to or exclude any portion of the unearned premium reserve subject to the 20% haircut in section 832(b)(4)(B).

[31] The history of these two provisions demonstrates the point. The Senate Finance Committee Report underlying section 848(g) cited to both assumption reinsurance and indemnity reinsurance authority in noting that "the bill repeals the present law requirement that reinsurers amortize ceding commissions. . . . Thus, ceding commissions incurred by a reinsurer on or after September 30, 1990, under any reinsurance contract are not required to be capitalized and amortized. . . ." Senate Report on the Revenue Reconciliation Act of 1990 Pub. L. No. 101-508, 136 Cong. Rec. S 15694 (daily ed. Oct. 18, 1990). The later enactment of section 197 was accompanied by a report that stated that "The bill applies to any reinsurance contract that is acquired from another person through an assumption reinsurance transaction (but not through an indemnity reinsurance transaction)." H.R. Rep. No. 111, 103d Cong., 1st Sess. 775 (1993). Further, section 197(f)(5) applies to "any amortizable section 197 intangible resulting from an assumption reinsurance transaction." Also, the proposed regulations provide that section 197(f)(5) is the operative and exclusive provision for determining the basis of the ceding commission (i.e., the "amount paid for the insurance contracts") in an assumption reinsurance transaction. Prop. Treas. Reg. section 1.197-2(g)(5)(i)(A). Consequently, since section 848(g) provides that no provision of law (other than section 848 or 197) shall require capitalization of the ceding commission of DAC contracts and section 197 requires amortization only of amounts "resulting from an assumption reinsurance transaction," a ceding commission derived in an indemnity reinsurance transaction of DAC contracts is fully deductible under section 848(g), after taking the amortization under section 848 into account.

[32] Prop. Treas. Reg. section 1.197-2(g)(5)(i)(D).

[33] *See* Prop. Treas. Reg. section 1.197-2(g)(5)(i)(D)(2)(iii).

tracts acquired by the reinsurer in assumption reinsurance transactions during the applicable taxable year; and, any reduction of specified acquisition expenses pursuant to an election under Treas. Reg. section 1.848-2(i)(4), relating to an insolvent ceding company, is disregarded.[34]

Losses on Dispositions of Acquired Insurance Contracts Under Section 197(f)(1)(A)

In general, losses on the later disposition of some of the acquired section 197 intangibles are not allowed and the basis of the disposed property is recovered by transferring it to the retained intangibles. Section 197(f)(1)(A) provides that if there is a disposition of any amortizable section 197 intangible but retention of any other such intangible acquired in the same transaction, no loss shall be recognized and appropriate adjustments to the basis of the retained intangibles shall be made for the loss. The Preamble notes that guidance on disposing of an insurance contract's intangible is needed because, "in contrast to other intangibles, subchapter L generally does not compute an 'amount realized' on the disposition of insurance contracts."

The proposed regulations establish special rules for applying the loss disallowance rules of section 197(f)(1)(A) to the disposition of "a section 197(f)(5) intangible." Such an intangible is the ceding commission in an actual or deemed assumption reinsurance transaction and is defined as an amortizable "section 197 intangible the basis of which is determined under section 197(f)(5)." Prop. Treas. Reg. section 1.197-2(g)(5)(ii). The general rule is that a disposition of a section 197 intangible is any event as a result of which, absent section 197, recovery of basis is otherwise allowed for federal income tax purposes. There is a lack of guidance on what constitutes the recovery of basis.

Although the need for guidance is acknowledged, the only guidance provided relates to a disposition of part of the insurance business acquired in an assumption reinsurance transaction where the disposition is pursuant to indemnity reinsurance. In that case, the taxpayer generally can recover basis, provided that its ceded indemnity reinsurance transfers the right to future income on the transferred contracts, and there is no experience refund, recapture option or other mechanism that enables the taxpayer to effectively retain the right to the future profits. Basis recovery will not be allowed where the reinsurance does not transfer the right to future income such as in excess loss reinsurance.[35] The amount of loss recognized on the disposition of the insurance contract intangible will be the difference between the basis of the intangible and any ceding commission received on ceding the insurance contracts. DAC is disregarded in determining the loss.[36]

Additional Points

As stated earlier, the proposed regulations attempt to apply a cap so that the assuming company will generally not recognize immediate premium income in excess of its deduction for an increase in tax reserves. However, if the proposed regulations do not apply, i.e., to a mere reinsurance transaction, the assuming company may still recognize premium income under the existing Treas. Reg. section 1.817-4(d) (which do not contain a cap). Consequently, it may be beneficial for the assuming company to acquire "significant business assets, in addition to insurance contracts, to which goodwill and going concern value could attach" in a negative ceding commission situation. As a result, no immediate premium income would be recognized by the reinsurer. On the other hand, if the reinsurer anticipated significant reserve increases after the acquisition, the application of the proposed regulations may require capitalization of an amount equal to the reserve increase deduction whereas the rules regarding post-acquisition increases to tax reserves for a mere reinsurance transaction appear to be more favorable.

Another potential planning benefit under the proposed regulations may be the elimination of the Target's PSA. Assume Target's SSA is $100 and its PSA is $200 and all of its stock is sold for $150 pursuant to a section 338(h)(10) election. If no reserves of Target are actually transferred to the selling shareholder, no portion of the existing SSA and PSA is transferred to the seller. Instead, there is a deemed distribution of $150 under the proposed regulations. Since the SSA is $100, this results in a distribution from the PSA of $50 and the remaining amount of the PSA is forgiven. The availability of this "benefit" will, of course, depend on the actual numbers and, therefore, will not apply to all section 338 transactions.

[34] Prop. Treas. Reg. section 1.197-2(g)(5)(i)(D)(2). The Preamble notes that comments are requested on alternative approaches to calculating the general expense deductions or other aspects of the interaction of DAC and section 197(f)(5).

[35] The Preamble requests comments as to whether other areas of guidance are appropriate. It would be helpful if future guidance confirmed that assumption reinsurance is treated in the same manner as the indemnity reinsurance of a portion of the acquired business. The question arises whether recovery of basis would apply when a particular policy acquired as part of the assumed block of business lapses. For example, if the reduction in reserves on a lapsed policy is greater than the benefit paid out, does such gain accelerate recovery of part of the basis assigned to the section 197 intangible?

[36] *See* Prop Treas. Reg. section 1.197-2(g)(5)(ii)(B).