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## MEMORANDUM

From: Mark H. Kovey and Lori J. Jones  
Date: April 12, 2006  
Re: Section 338/1060 Insurance Company Regulations

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The IRS has finally released final and temporary regulations under sections 197, 338, 381, 848 and 1060, dealing with taxable reinsurance transactions by insurance companies. The two types of transactions highlighted in the regulations are elections under section 338 (whereby a taxable purchase of the stock of the target insurance company is treated instead as a deemed assumption reinsurance transaction) and an actual indemnity or assumption reinsurance transaction where the assuming company also acquires significant business assets to which goodwill or going concern value could attach under section 1060 principles. In addition, rules are adopted on when various tax attributes that may be unique to insurance companies carryover to the acquiring company in certain liquidations and reorganizations subject to section 381.

The regulations retain the overall framework of the proposed regulations, but make some helpful modifications in connection with certain controversial issues. For example, in response to numerous comments, the regulations are effective with respect to transactions occurring on or after April 10, 2006, but contain an election to apply the regulations retroactively. Perhaps the most significant change is a revision to the rules requiring capitalization as a result of increases in the tax reserves allocable to acquired insurance contracts. The regulations also confirm that the unamortized DAC balance may be transferred to a nonlife insurance company under section 381 but add the requirement that the successor must acquire 50% or more of the transferor corporation's insurance business in order to succeed to the entire balance. In addition, despite taxpayer requests, the regulations do not elaborate on the definition of a significant business asset for purposes of determining whether a reinsurance transaction is subject to the new provisions under section 1060 or is treated as

mere reinsurance subject to the general rules of Treas. Reg. § 1.817-4(d). Comments on the temporary regulations, also issued as proposed regulations, must be received by July 10, 2006.

Highlights of the regulations include:

Retroactive Elections: The regulations permit an election to apply the final section 338 regulations, in whole, to qualified stock purchases which occurred before April 10, 2006, if all taxable years for which the consequences of the section 338 election affect the computation are open. If a section 338(h)(10) election was made for a domestic target or a section 338 election was made for a foreign target, either the seller or the purchaser can independently choose to apply the regulations retroactively. If a section 338 election was made for a domestic target, both old and new target must agree in order to apply the regulations to transactions that occurred prior to April 10th. For application of the new section 1060 rules, the election to apply the regulations retroactively can be made independently by either the purchaser or the seller. The new rules for the carryover of insurance company tax attributes under section 381 also provide for a joint election to apply them retroactively.

Capitalization of Reserve Increases: The proposed regulations were heavily criticized for requiring increases to paid losses and unpaid loss reserves after the actual or deemed reinsurance transaction to be offset by an increase in premium income with the same amount capitalized by an increase to the basis of the assets acquired in the reinsurance. Under the revised regulations, the concept is retained but there is no 2% safe harbor for reserve increases or any rule limiting capitalization to the first four years after the reinsurance. Instead, as set forth in Treas. Reg. § 1.338-11T(d)(1), new target (or the assuming company) is treated as receiving additional premium income for the taxable year in which new target increases its reserves for acquired contracts, which is, in turn, required to be capitalized as part of the AGUB (adjusted grossed-up basis) computation used to determine the basis of the acquired assets. However, the additional premium deemed received under this provision is limited to the excess, if any, of the fair market value of old target's assets acquired by new target in the deemed or actual reinsurance transfer over the AGUB allocated to the acquired assets. In other words, as stated in the preamble, capitalization to offset reserve increases is no longer required once the assets described in Classes 1 through V (assets other than intangible assets and goodwill) have a basis equal to their fair market value at the time of the acquisition. The preamble describes this as requiring capitalization only in situations involving an understatement of insurance reserves by old target, i.e., a "bargain purchase" (where the fair market value of the assets received exceeds the amount of the tax reserves assumed). This provision in the temporary and proposed regulations still contains an exception for companies in receivership and for increases in reserves subject to section 807(f).

Interplay of DAC and Section 197 Amortization: The regulations build on the proposed regulations and the existing "DAC" regulations under Treas. Reg. § 1.848-2 to deal with the interplay of the amortization of the ceding commission under section 197(f)(5) and the amortization of DAC

under section 848, when the transaction is an actual or deemed assumption reinsurance transaction. They take into account the limit on general deductions and supply useful rules on determining the amount of general deductions for each actual or deemed assumption reinsurance transaction. The regulations also clarify that the ceding and assuming companies are permitted to make the election under Treas. Reg. § 1.848-2(g)(8) to determine the amount of expenses capitalized under section 848 without regard to the reinsurer's general deduction limitation. Because of this and other modifications, the preamble notes that the regulations generally allow the reinsurer to amortize a larger amount over the ten-year period under section 848 than the 15-year period under section 197(f)(5), as compared to the proposed regulations.

Valuation of Insurance Contracts: The regulations retain the general rule that requires the ceding commission or insurance in force (called the "insurance contracts" in the regulations) to be determined on the basis of tax reserves, rather than statutory or GAAP reserves, but make several modifications concerning the computation of the amount of the section 197(f)(5) intangible in the case of an actual or deemed assumption reinsurance transaction. The general rule is that the amount allocated to an insurance contract is the amount of the ceding commission "a willing reinsurer would pay a willing ceding company in an arm's length transaction for the reinsurance of the contracts if the gross reinsurance premium for the contracts were equal to old target's tax reserves." Treas. Reg. § 1.338-11(b)(2). The preamble acknowledges that comments questioned the use of tax reserves for this purpose as opposed to GAAP or statutory reserves, but the IRS concluded that the use of tax reserves is consistent with other areas in which tax, not GAAP or statutory reserves, are used to compute taxable income. Notwithstanding the regulations are consistent in using tax reserves in determining the ceding commission, the amount of net consideration for DAC purposes and the amount of the net reinsurance premium, this rule may continue to cause questions in the future.

Other issues include:

Section 846(e): In response to comments, the temporary regulations contain a new rule that treats new target and old target as the same corporation for purposes of a section 846(e) election to use an insurance company's own historical loss payment pattern to discount unpaid loss reserves, notwithstanding the general approach of section 338 which treats new target as a new taxpayer that must make new elections. Therefore, after a section 338 election where old target had a section 846(e) election in effect, new target can choose to continue to use the historical loss payment pattern of old target or may revoke the election.

Section 815 Accounts: Comments were rejected to change the proposed rule that relates the carryover of the policyholders surplus account, shareholders surplus account and other section 815 accounts in a tax-free transaction subject to section 381 to the percentage of the business transferred to the acquiring corporation. Thus, the final rule continues to provide if an acquiring corporation in a

transaction to which section 381 applies acquires less than 50 percent of the transferor's insurance business, then the acquiring corporation succeeds only to a ratable portion, determined by insurance reserves, of the transferor's section 815 accounts. As a consequence, the amount in the PSA not carried over to the acquiring corporation will be taken into income by the transferor to the extent the net value of assets distributed to shareholders exceeds the SSA. Also, in a section 338 transaction, the policyholders surplus account is taken into income by the old target to the extent the purchase price of the target stock exceeds the SSA. However, given the change in law regarding section 815 generally, this is not likely to be a significant issue going forward for many companies.

Negative Ceding Commission: The regulations adopt the proposed rule requested by the industry that prevents the new target (or the assuming company) from having premium income in excess of its reserve deduction when the value of assets received is greater than the tax reserves assumed in the actual or deemed reinsurance transaction. However, no change was made to the rules in Treas. Reg. § 1.817-4(d) which require the reinsurer to recognize this income in reinsurance transactions not subject to section 1060 because they are "mere reinsurance." Similarly, the regulations retain the rule that when there is a negative ceding commission, the ceding company will incur a capital loss rather than a net ordinary deduction on transferring assets to the reinsurer as the reinsurance premium.

Section 848(g): The preamble notes that comments requested clarification that the ceding commission paid in an indemnity reinsurance transaction (and thereby not subject to amortization under section 197(f)(5)) is immediately deductible by the reinsurer under section 848(g), but, strangely, the regulations are silent on the matter. However, the regulations make clear that section 197(f)(5) applies only to assumption reinsurance transactions.

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We will be preparing a more in-depth analysis of the final and temporary regulations which will be published in the June issue of the Insurance Tax Review and will be available on our firm website, [www.scribnerhall.com](http://www.scribnerhall.com).