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### IRS Releases Final and Temporary Regulations Under Section 338

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On April 7th the IRS released the long awaited final and temporary regulations relating to an actual or deemed acquisition of an insurance company's assets. The final regulations under Sections 338 and 1060 apply to:

- an actual or deemed acquisition of an insurance company's assets pursuant to an election under Section 338;
- a sale or acquisition of an insurance trade or business subject to Section 1060; and
- an acquisition of insurance contracts through assumption reinsurance.

Final regulations under Section 381 were issued to address the effect of certain corporate liquidations and reorganizations on certain tax attributes of insurance companies. Temporary and proposed regulations were also released under the following Sections:

- Section 197 relating to the determination of adjusted basis of amortizable Section 197 intangibles with respect to insurance contracts;
- Section 338 relating to increases in reserves after a deemed asset sale; and,
- Sections 338 and 846 relating to the effect of a Section 338 election on a Section 846(e) election.

The proposed regulations were released in March 2002 and generally treat the deemed transfer of insurance or annuity contracts pursuant to a Section 338 election consistently with the treatment of assumption reinsurance transactions entered into in the ordinary course of business. In addition, the proposed regulations provide similar rules for acquisitions of insurance businesses governed by Section 1060, whether affected through assumption or indemnity reinsurance. While the proposed regulations provided welcome guidance on many of the tax intricacies of such transactions, practitioners took issue with some of the proposed guidance and asked for further clarification on the several unclear issues. In general, the final and temporary regulations published last week follow the approach of the proposed regulations. The following is a summary of material departures between the 2006 final and temporary regulations and the 2002 proposed regulations.

#### **Reserve Increases by New Target After the Deemed Asset Sale**

The 2002 proposed regulations generally require capitalization of increases in reserves for the acquired contracts in excess of cumulative annual increases of two percent per year from the acquisition date reserves. The IRS received many comments relating to the rule requiring capitalization for certain increases in reserves post-transaction. Many tax practitioners took issue with this approach due to the disregard shown for the Subchapter L provisions that apply to the determination of tax basis insurance reserves and losses incurred.



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In response to comments, the 2006 temporary and final regulations adopt the "asset model" capitalization requirement of the proposed regulations but in limited form (the compromise given to accommodate the "service model" generally used to effect insurance transactions). Under the temporary regulations, capitalization is required only for increases in reserves that clearly reflect a so called "bargain purchase". Because the temporary regulations limit the total amount of capitalization for increases in reserves for acquired contracts, the IRS believes that it is no longer necessary to provide a time limit on when increases in reserves for acquired contracts are to be capitalized or to provide a floor below which increases in reserves are not capitalized. However the temporary regulations retain the other limits on capitalization in the proposed regulations.

**PwC Observes:** The more limited application of the capitalization provision is a welcome one, but not a complete win from the taxpayer's perspective. We can still feel the IRS' struggle with accommodating insurance transactions in an asset acquisition model. However, taxpayers continue to have a clear methodology for determining whether a bargain purchase exists and capitalization is required, thus removing much of the uncertainty in applying this provision.

### **Determination of adjusted basis of amortizable Section 197 intangibles**

The 2002 proposed regulations resulted in significant complications and uncertainty in addressing the interplay of Sections 197 and 848 in a Section 338 transaction. The IRS has attempted to ease the burden of the interdependent calculations by providing simplifying assumptions and clarifications.

Under the 2006 temporary and proposed rules, the amount of expenses capitalized under Section 848 as a result of an assumption reinsurance transaction equals the lesser of (A) the required capitalization amount for the transaction, or (B) the amount of general deductions allocable to the transaction. The temporary and proposed rules also clarify that in the event that the acquirer purchases more than one category of specified insurance contracts, the determination of the amount capitalized under Section 848 is made as if each category were transferred in a separate assumption reinsurance transaction. Under the temporary and proposed rules, an acquirer will determine its general deductions as if the entire amount paid or incurred for the acquired contracts were allocable to an amortizable Section 197 intangible. In the event that the amount of required capitalization exceeds the general deductions limitation, taxpayers will have the ability to agree to forgo the general deductions limitation in making the determination.

The temporary and proposed regulations generally apply, on a cut-off basis, to acquisitions and dispositions on or after April 10, 2006. However, Taxpayers may elect to apply the regulations on a retroactive basis to a transaction, with the resulting adjustment being treated as a Section 481(a) adjustment.

### **PwC Observes:**

The simplifying assumptions appear to achieve the intended result and are purported by the IRS to result in more of the purchase price being allocated to shorter-lived Section 848 DAC (maximum 10 year life) versus Section 197 intangibles (15 year life).



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### **Effect of Section 338 Election on Section 846(e) Election by Old Target**

The proposed regulations did not provide any special rules under Section 846 for new target to apply old target's historical loss payment pattern as a result of a Section 846(e) election made by old target. Because new target is generally treated as a new corporation that may adopt its own accounting methods without regard to the methods used by old target, it was unclear whether an election pursuant to Section 846(e) would carryover to New Target in a Section 338 transaction.

The 2006 temporary regulations contain a new rule that treats new target and old target as the same corporation for purposes of the Section 846(e) election. Thus, New Target will continue to have the ability to use Old Target's historical loss payment pattern for purposes of discounting reserves, unless it revokes the election made by Old Target and defaults to the industry-wide factors prescribed by the IRS. Moreover, the 2006 temporary regulations contain a provision that will allow New Target to use Old Target's historical payment pattern in making a new Section 846(e) election.

**PwC Observes:** This issue was hotly debated upon the issuance of the proposed regulations. The final and temporary regulations provide welcome clarity and conclusion on an issue that is just from the taxpayer's perspective.

### **Application of IRC Section 381**

The final regulations use much of the proposed regulations in this area. However, the final regulations do provide a significant clarifying point with respect to the application of Section 381 to asset acquisitions: Section 381 applies to tax attributes, including DAC and Policyholders Surplus Accounts (PSAs) whether the acquirer is a life or non-life insurance company.

The 2002 proposed regulations provide that if one corporation distributes or transfers at least fifty percent (50%) of an insurance business to another corporation in a transaction to which Section 381 applies, then the acquiring corporation succeeds to the distributor corporation's shareholders surplus account (SSA), PSA, and other accounts. However, under the proposed regulations, if an acquiring corporation acquires less than 50% of the corporation's insurance business, then the acquiring corporation succeeds only to a ratable portion of the corporation's SSA, PSA, and other accounts. Practitioners questioned whether the IRS has the authority to provide for ratable allocation of the accounts in a Section 381 transaction. The IRS believes that the rule in the proposed regulations is appropriate and that there is sufficient authority for the proposed rule. Therefore, the 2006 final regulations adopt the rule in the proposed regulations, but provide that a successor corporation can succeed to these accounts whether it is a life or non-life company.

The 2002 proposed regulations also provide that any remaining balances of DAC or excess negative DAC carry over to a successor insurance company in a Section 381 transaction. The 2006 final regulations retain the rule in the proposed regulations that the remaining balances of DAC or excess negative DAC carry over to a successor insurance company in a Section 381 transaction. However, the 2006 final regulations adopt the application of the 50% rule enumerated above with respect to SSAs and PSAs to DAC.



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**PwC Observes:** This was another of the often-debated issues stemming from the 2002 proposed regulations. The IRS has ruled favorably with respect to this issue, allowing for the carryover of the PSA accounts to non-life companies. However, with the Section 815(g) special distribution rules in effect for the 2005-2006 period allowing for the tax-free distribution of PSAs, it will be interesting to see if taxpayers continue to use PSAs and therefore have a need for such a provision.

The IRS also addressed taxpayer comments on the following two items but declined to make changes in the proposed regulations:

### **Recovery of Basis on Dispositions of Acquired Contracts**

The 2002 proposed regulations provide that basis recovery with respect to a Section 197(f)(5) intangible transferred through indemnity reinsurance is permitted when sufficient economic rights relating to the insurance contracts that gave rise to the Section 197(f)(5) intangible have been transferred.

Several commentators requested that the final regulations clarify when sufficient economic rights in a Section 197(f)(5) intangible are transferred through indemnity reinsurance as well as additional examples to address situations relating to transfers through indemnity reinsurance of less than 100 percent of the insurance contracts that gave rise to the Section 197(f)(5) intangible. The IRS declined to provide examples or further clarification, stating that “the rules contained in these regulations should refer to general tax principles,” and that, as needed, the IRS will address these issues in future published guidance.

### **Allocation of ADSP and AGUB to Specific Insurance Contracts**

The 2002 proposed rules provide that for purposes of allocating AGUB and ADSP, the fair market value of a specific insurance contract or group of insurance contracts 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 for the contracts. The IRS reiterated that tax reserves are the basis for valuing the contracts.

For additional information please call Anthony DiGilio at (202) 414-1702 or contact your local insurance tax professional.