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# A Practical Guide for Determining Whether a Section 338(h)(10) Election Should Be Made for a Target Insurance Company

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In March 2006, the Internal Revenue Service (IRS) finalized regulations which provide helpful rules for determining the likely tax consequences of a section 338(h)(10)<sup>1</sup> election on the disposition of an insurance company.<sup>2</sup> T.D. 9257 (April 7, 2006). However, as discussed below, despite the helpful guidance, there are a number of considerations—both tax and nontax—which must be taken into account before deciding on making the election. These considerations begin with the basic question as to whether the respective parties, the Buyer and the Seller, will have a better tax answer with or without an election. Before discussing the evaluation process, a summary of the basic rules is necessary.

## Stock Sale Without Section 338(h)(10) Election

If a Buyer purchases 100 percent of the stock of a Target insurance company without the election, the Seller's gain or loss is determined by comparing the Seller's aggregate stock basis to the amount realized on the sale. The tax basis of Target's assets stays the same as it was prior to the sale. All of Target's tax attributes remain with Target although their use by the Buyer or the Buyer's consolidated group may be limited under various Code sections, such as the limitation on the use of loss carryovers and built-in loss under section 382, or the section 1504(c)(2) inability of a Target life insurance company to immediately join in a new life/nonlife consolidated group. The tax basis in Target's assets includes the unamortized balance of specified policy acquisition expenses under section 848 as well as the remaining balance of any existing section 197 intangible in the hands of Target. These amounts continue to be amortized on the same amorti-

zation schedule utilized by Target prior to the sale. On the other hand, the Buyer has a tax basis in Target stock equal to the purchase price plus capitalized expenses. In the event of a stock purchase when Target is a member of a consolidated group, Target retains tax liability for all consolidated return years for which it was a member under Treas. Reg. § 1.1502-6.

## Stock Sale With Section 338(h)(10) Election

In contrast, if a section 338(h)(10) joint election is made by the Seller and the Buyer for insurance company Target, the election treats "Old" Target's assets as having been sold to "New" Target pursuant to an assumption reinsurance transaction and disregards the stock sale for federal income tax purposes.<sup>3</sup> Old Target recognizes gain or loss on the deemed sale of its assets, which includes those assets deemed transferred as consideration in the hypothetical assumption reinsurance transaction, based on the allocation of the "adjusted deemed sales price" (ADSP) among its assets. The deemed sale of assets is followed by the deemed liquidation of Old Target into its shareholder[s].<sup>4</sup> The liquidation may be treated as tax-free pursuant to section 332 if the general rules of that provision are satisfied. In that case, Old Target's tax attributes, such as loss carryovers, remain with the corporation that held 80 percent of the vote and value of its stock. However, if the provisions of section 332 are not satisfied, the liquidation of Old Target into its shareholder will be taxable under section 331 to the shareholder and any remaining tax attributes will be lost.<sup>5</sup> In either case, Old Target's taxable year will close at the end of the day in which the stock sale occurs. In addi-

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tion—even though for most federal income tax purposes New Target will be treated as an unrelated party to Old Target—there are exceptions to this rule. The most important is the exception whereby New Target continues to retain tax liability under Treas. Reg. § 1.1502-6 for years in which it joined another consolidated group.<sup>6</sup>

The assumption reinsurance transaction which is deemed to occur pursuant to section 338(h)(10) is also generally treated in the same manner as an actual assumption reinsurance transaction, with certain exceptions.<sup>7</sup> The regulations provide guidance on how to determine the fair market value of assets deemed transferred in the assumption reinsurance transaction by requiring Old Target to value the amount of its insurance contracts, *i.e.*, insurance in force or ceding commission. The fair market value of the insurance contracts is the amount a willing reinsurer would pay a willing ceding company in an arm's length transaction for the contracts if the gross reinsurance premium for the insurance contracts were equal to the ceding company's tax reserves for the insurance contracts.<sup>8</sup> Old Target will receive a deduction equal to the fair market value of assets treated as transferred for the assumption of liabilities by New Target less the value of the insurance contracts and will have income for the release of the insurance tax reserves. Section 848 will apply as if there is an actual reinsurance transaction so that in most cases Old Target will be able to deduct the remaining amount of its unamortized section 848 balance.<sup>9</sup> On the other hand, New Target must recompute the amount of unamortized specified policy acquisition expenses it receives in the deemed assumption reinsurance transaction and will have a new amortization period beginning with a one-half year amortization in the year of the transaction.

The section 338 regulations contain several rules which are unique to section 338(h)(10) elections for Target insurance companies. First, the regulations address (and eliminate) the problem created if a "negative ceding commission" was paid to New Target and the resulting concern that New Target would have immediate premium income to the extent that the assets received exceeded the assumed insurance tax reserves. The regulations prevent immediate premium income to New Target by stating that the gross amount of the reinsurance premium paid by Old Target to New Target will be deemed equal to Old Target's closing tax reserves.<sup>10</sup> The rule in effect works as a cap because neither party can be treated as transferring or receiving a reinsurance premium that exceeds the tax reserves actually or deemed transferred. If the amount allocable to the insurance contracts is nega-

tive, New Target will likely have reduced asset basis as a cost for not having immediate net premium income while Old Target will have a reduced underwriting deduction on the transfer but also will have reduced gain or increased loss on the deemed or actual sale of its assets. Consequently, for Old Target, this rule may result in a change in character from an ordinary deduction in the case of mere reinsurance (subject to Treas. Reg. § 1.817-4(d)) to a capital loss in the case of a section 338(h)(10) election.

Another special rule in the section 338 regulations that does not apply to an actual reinsurance transaction is that certain post-transaction reserve deductions must be capitalized by New Target.<sup>11</sup> This capitalization will often apply only to those situations where the deemed asset sale involves a negative ceding commission.<sup>12</sup> Capitalization is not required for post-acquisition increases in reserves while the reinsurer is under a state receivership proceeding or to the extent the deduction for the reserve increase for a life insurance company is spread over ten years under section 807(f).<sup>13</sup> Other special provisions in the section 338 regulations relate to section 846(e) elections, rules under section 815 regarding policyholder surplus accounts (which may not have much practical impact going forward), and rules regarding section 847 estimated tax payments on unpaid losses.<sup>14</sup>

New Target takes a basis in the assets pursuant to an allocation of "adjusted grossed up basis" (AGUB).<sup>15</sup> Both ADSP and AGUB are basically determined by grossing up the purchase price by the amount of Target's tax reserves plus other liabilities.<sup>16</sup> Allocation of ADSP and AGUB is done on a residual method based on the respective classes of assets. Class VI includes section 197 intangibles, including any value allocated to the insurance contracts but other than goodwill and going concern value. Since these intangibles can generally be amortized over 15 years and usually had no tax basis in the hands of Old Target, the existence of sufficient AGUB to allocate to these intangibles is an important factor in determining whether to make an election under section 338(h)(10). If application of the AGUB rules results in no amount treated as paid for the insurance contracts, it is likely that there is no new section 197 intangible that would be created as a result of the section 338(h)(10) election, thus reducing the benefit to the Buyer from such an election.

**Is the Election Beneficial to the Buyer and/or the Seller from a Tax Perspective?**

These are the primary questions that should be asked in

order to determine whether a section 338(h)(10) election is preferable. Of course, this assumes that both parties are at least willing to consider making the election since joint consent is required.

1. Is the Seller's basis in Target's stock higher than Target's net inside asset basis?
2. What are the consequences of the deemed asset sale? Is the net asset basis in the assets increased or decreased?
3. What are the consequences of the assumption reinsurance transaction? What is the value of the insurance contracts? What are the expected results under section 848?
4. What is the amount, if any, of Old Target's existing section 197 intangible or New Target's section 197 intangible in the event a section 338(h)(10) election is made? What is the expected utilization of the amortization of the section 197 intangible?
5. Is there any other benefit to a stock sale without a section 338(h)(10) election that should be considered? For example, can any of Target's tax attributes be utilized in a beneficial manner by the Buyer? Is Target expected to increase its tax reserves after the transaction (in a manner that would otherwise be limited under the section 338(h)(10) rules)?

### Is the Election Beneficial to Either the Buyer and/or the Seller Taking into Account Tax as Well as any Indemnifications or Purchase Price Adjustments?

1. What indemnifications for Target and Target's consolidated tax liability can be agreed upon between the Buyer and the Seller? (Note that potential liability under Treas. Reg. § 1.1502-6 is not eliminated in either the straight stock sale or the sale with a section 338(h)(10) election.)
2. What indemnifications can be agreed upon dealing with potential tax detriments to the Buyer such as the application of section 848? Is this outweighed by the increase in the section 197 intangibles? Are there any purchase price adjustments related to potential tax benefits to the Buyer or the Seller?
3. What are the expected costs in making sure that any indemnifications are properly implemented?

In all likelihood, the key factor in determining whether the section 338(h)(10) election should be made is whether New Target will receive a new benefit (after any purchase price adjustments and other negotiated factors) from a newly-created section 197 intangible. ◀

#### End Notes

- <sup>1</sup> References to section are to sections of the Internal Revenue Code of 1986, as amended.
- <sup>2</sup> This article does not discuss the potential application of a section 338(g) election to a domestic target because it generally results in a double layer of tax on the stock sale and on the deemed asset sale. A section 338(h)(10) election generally results only in a single layer of tax because the stock sale is disregarded. In addition, this article does not address directly the considerations in determining whether a section 336(e) election to treat the sale as a deemed asset sale and liquidation similar to a section 338(h)(10) election is beneficial. See Prop. Treas. Reg. § 1.336-0 to 1.336-4. Note that the section 336(e) election as set forth in recent proposed regulations is not a joint election between the Buyer and Seller but rather an election made solely by Seller.
- <sup>3</sup> Treas. Reg. § 1.338(h)(10)-1(d).
- <sup>4</sup> Treas. Reg. § 1.338(h)(10)-1(d).
- <sup>5</sup> See, e.g., Rev. Rul. 2008-25, 2008-21 I.R.B. 986.
- <sup>6</sup> See Treas. Reg. § 1.338(h)(10)-1(b)(3)(ii).
- <sup>7</sup> Treas. Reg. § 1.338-11(c).
- <sup>8</sup> Treas. Reg. § 1.338-11(b)(2). It is unclear how this rule should be interpreted. In most actuarial valuations of insurance in force, the amount of the distributable earnings is based on statutory reserves, which may differ from tax reserves. One way to interpret the rule is to value the insurance contracts and then reduce the amount by the excess of the statutory over the tax reserves. This would likely result in a lower value of insurance in force for tax purposes, as compared to a normal actuarial valuation. On the other hand, one could interpret the rule as requiring the substitution of tax reserves for statutory reserves in determining distributable earnings, which would have the result of increasing the value of insurance in force (because the liability for tax purposes would be lower). The problem with the latter approach is that it probably was not what was intended by the drafters. Thus, until and unless further guidance is issued, the former approach set forth above appears to be the more reasonable interpretation of the regulation. P. Winslow and S. Mitchell, *Valuation of Insurance in Force for Tax Purposes*, T<sup>3</sup>: Taxing Times Tidbits, 9 TAXING TIMES, Vol. 1, Issue 3 (December 2005).
- <sup>9</sup> Treas. Reg. § 1.338-11(f).
- <sup>10</sup> Treas. Reg. § 1.338-11(c)(2).
- <sup>11</sup> Treas. Reg. § 1.338-11(d).
- <sup>12</sup> Treas. Reg. § 1.338-11(d)(4).
- <sup>13</sup> Treas. Reg. § 1.338-11(d)(2).
- <sup>14</sup> Treas. Reg. § 1.338-11(e), (g) and (h).
- <sup>15</sup> Treas. Reg. § 1.338-11(b)(2).
- <sup>16</sup> Treas. Reg. § 1.338-11(b)(1).

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