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Highlights of the Recent Guidance on Insurance Company Acquisitions

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Final tax regulations issued in April provide helpful guidance on the acquisition of insurance companies pursuant to an election under section 338 of the Internal Revenue Code and the reinsurance of blocks of insurance when accompanied by the acquisition of other intangible assets, such as a customer list or a distribution network. The new regulations apply to all types of insurance companies, life, property casualty, health, title and so forth, and potentially to all forms of reinsurance (including indemnity, assumption and retrocessions). The following describes many significant issues and discusses the fact that "mere" reinsurance remains subject to the old regulations under Treas. Reg. section 1.817-4(d), which may result in a different answer for federal tax purposes.

After waiting for over 20 years since the enactment of section 338, the regulations finally instruct insurance companies how to treat an election under section 338 as a deemed assumption reinsurance transaction. When the stock of a target insurance company (the target) is purchased, an election under section 338(g) or section 338(h)(10) will result in the transaction treated for federal income tax purposes as if there is no sale of the stock of the target. Instead, the transaction is treated as a taxable sale by the "old" target of all its assets to the "new" target, followed by a deemed liquidation of the old target into its selling shareholder, and the new target is treated as a new taxpayer after the deemed asset sale. The deemed asset sale requires the old target to recognize gain or loss on the deemed transfer of its assets and the new target to receive a new tax basis in those assets (usually at the current fair market value). In addition, the regulations treat the deemed asset sale as a taxable assumption reinsurance transaction between the old target and the new target, which impacts on various tax issues including reserves, tax DAC under section 848 and other aspects of determining underwriting income. Some of the issues are covered by temporary regulations (also released as proposed regulations) so taxpayer comments can be received before final adoption of the rules. However, the final and temporary regulations are effective now.

The adopted regulations also apply to a novel category of reinsurance, one defined in the regulations as reinsurance combined with the transfer of significant business assets that is an "applicable asset transaction" defined in section 1060. Mere reinsurance of insurance contracts is not an applicable asset acquisition even if it enables the reinsurer to establish a customer relationship with the policyholders. Treas. Reg. section 1.1060-1(b)(9). The transfer of an insurance business is an applicable asset acquisition if the purchaser acquires significant business assets, in addition to the reinsurance of insurance contracts, to which goodwill and going concern could attach. Little further guidance is provided. It appears to us that reinsurance of a block of business when there is also a transfer of the right to solicit customers, the distribution or marketing operation or the core operating software for underwriting and administering the book of business will constitute significant business assets to bring the transaction under the new section 1060 rules. Assumption reinsurance, indemnity reinsurance and retrocessions can be applicable asset acquisitions subject to section 1060 but only if there is also the transfer of significant business assets. See Treas. Reg. section 1.1060-1(b)(5).

Assumption Reinsurance Rules Apply With Cap to Assuming Company

The deemed sale of assets pursuant to a section 338 election is treated as assumption reinsurance for tax purposes, but special rules are provided under section 338 that differ in some respects from the existing assumption reinsurance regulations at Treas. Reg. section 1.817-4(d). See Treas. Reg. section 1.338-1(a)(2). Those same provisions are also applicable to a section 1060 reinsurance transaction. Thus, the new regulations apply to deemed reinsurance (section

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338 election) and actual reinsurance (section 1060 reinsurance transaction).

The closing tax reserves of the old target (ceding company) are treated as fixed, not contingent, liabilities in determining the old target's gain or loss on the deemed or actual sale of its assets (based on the total amount of consideration received) and the total amount of tax basis of the assets deemed or actually acquired by the new target (assuming company). Treas. Reg. section 1.338-11(b). Following the usual method applied for other section 338 and 1060 transactions, the residual method is used to allocate the total amount of consideration and total amount of tax basis among all classes of transferred assets, including the "insurance contracts" (which is the new regulations' term for the ceding commission or the insurance in force value). The residual method allocation will be applied before applying the reinsurance tax rules so that the residual method determines what amount is allocated to the ceding commission before applying the reinsurance tax principles to the actual or deemed reinsurance transaction.

The final regulations responded favorably to insurance industry requests to prevent immediate premium income to the assuming company of "phantom" income when there is a negative ceding commission in the actual or deemed reinsurance transaction. In theory, there can be a negative ceding commission whenever the agreement requires the ceding company to transfer assets with a greater fair market value than the reserves transferred. This can occur for many reasons, such as under-reserving by the ceding company or the nature of the bargain struck by the parties. However, because tax rules utilize the tax measure of reserves (and not statutory, GAAP or other measures), the usually lower amount of tax reserves can create a negative ceding commission for tax purposes when one did not exist under another measure of the reserves. When the tax reserves are less than the statutory reserves, the required transfer of the same amount of assets will result in either a negative ceding commission for tax purposes or a reduced positive ceding commission.

The new regulations prevent immediate premium income to the new target (assuming company) by declaring that the gross amount of the reinsurance premium paid by the old target (ceding company) to the new target will be deemed equal to the old target's closing tax reserves in all cases. Treas. Reg. section 1.338-11(c)(2). Although not stated as a "cap," the rule 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 cap applies and the amount allocable to the insurance contracts is negative, the new target will likely have reduced asset basis as a cost for not having immediate net premium income while the 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 the ceding company this may be a change of character from ordinary deduction to capital loss while for the assuming company there is a timing item and probably also a change in character.

Valuation of Insurance in Force

Under the regulations, the amount allocable to the insurance contracts is taken into account in determining the ceding company's income or gain (or loss) and the assuming company's asset basis. For this purpose, the regulations provide that 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 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. Treas. Reg. section 1.338-11(b)(2). In order to maintain consistency with other provisions of the code whereby the amount of the insurance liability for tax purposes is the tax reserve, the regulation adopts a value of insurance in force, which artificially looks to tax reserves rather than statutory reserves. As indicated earlier in the article, this could result in a negative ceding commission in the situation where statutory reserves exceed tax reserves, and the assets transferred (or deemed transferred) for the insurance liabilities equal the statutory reserves. Despite numerous comments being filed by the industry in response to this definition in the proposed regulations, the IRS kept the same definition in the final regulations and did not provide an illustration as to how this amount would be determined.

One way to interpret the rule is that the value of the insurance contracts should be determined on the basis of standard actuarial principles (using statutory reserves) and then the resulting amount should be reduced by an amount equal to 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 essentially the liabilities for tax purposes would be lower). The problem with this approach is that it probably was not what was intended. Thus, until and unless further guidance is issued, the two-step approach set forth above appears to be the more reasonable interpretation of the regulation.

Reinsurance as DAC Transaction

The deemed asset sale under section 338 is also treated as reinsurance for purposes of applying the tax DAC provisions under section 848. Section 848 requires the capitalization and amortization generally over ten years of specified policy acquisition expenses on life insurance and annuity contracts. The existing rules in Treas. Reg. section 1.848-2 for actual reinsurance transactions are also applied to the deemed reinsurance under section 338 although additional guidance in the final and temporary regulations provide helpful detail. These rules also apply to a section 1060 actual reinsurance transaction. Thus, the negative capitalization amount that generally results from the ceding company's reinsurance of liabilities under life, annuity and noncancellable accident and health contracts 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 produce a current expense deduction. Under the DAC tax consistency approach, the assuming company will usually have a positive DAC in the same amount that must be capitalized and amortized generally over ten years. The positive and negative capitalization amounts are 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. The final regulations specify that the parties to the actual or deemed reinsurance transaction can make the election under Treas. Reg. section 1.848-2(g)(8) to determine the amount of expenses capitalized under section 848 without regard to the reinsurer's general deduction limitation. Useful examples illustrate how to calculate the tax DAC consequences of an actual or deemed reinsurance transaction, including the method of determining what portion of the ceding commission is amortizable under the ten-year regime of section 848 and what portion is subject to 15-year amortization under section 197(f)(5). See Temp. Treas. Reg. section 1.197-2T(g)(5)(ii)(D).

The regulations also limit the carryover of any remaining tax DAC attributes. Thus, if the parent company of the old target that is subject to an election under section 338(h)(10) is an insurance company, the DAC attributes will carryover to the parent under section 381(c)(22) on the deemed liquidation of the old target. However, if the parent is not an insurance company, any remaining unamortized DAC in the old target will be immediately deductible to the old target and any remaining excess negative capitalization amount in the old target will be eliminated.

Section 815 PSA Triggered Generally

The regulations unkindly trigger tax on "phase III" income in most section 338 transactions, although most companies will have eliminated their policyholders surplus account (PSA) by the end of 2006 and thus will have no concern about adverse results under this provision. It provides as a general rule that when a target stock life insurance company is sold pursuant to a section 338(g) election, an amount generally equal to the purchase price of the target's stock will be treated as a distribution under section 815. Treas. Reg. section 1.338-11(g). If the purchase price exceeds the shareholders surplus account (SSA), an amount will be taken into income as a distribution out of the PSA. If the purchase price does not exceed the combination of the SSA and the PSA, any remaining PSA is not triggered and should go untaxed because the new target will not inherit the remaining PSA. An exception to the general rule is that, if 50 percent of more of the old target's insurance business is in fact transferred to Target's parent life company, the PSA and other section 815 accounts will carryover to the parent in a section 338(h)(10) election. When less than 50 percent is transferred, the parent will succeed to a pro rata portion of the section 815 accounts, based on a ratio of the transferred reserves to total reserves. The remaining amount of PSA not carried over to the parent is taken into income.

Three Provisions of Most Interest to P&C Companies

Certain Post Transaction Reserve Deductions Must Be Capitalized—The regulations require capitalization of increases to unpaid loss reserves (including loss claims

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and loss adjustment expenses) to the extent that, under the regulations, the deemed or actual reinsurance transaction includes a negative ceding commission. Temp. Treas. Reg. section 1.338-11T(g). Capitalization is not required for post-acquisition increases in reserves while the insurer 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). Temp. Treas. Reg. section 1.338-11T(d)(2).

Capitalization is required if the reserve is increased at any time after the reinsurance transaction if the assuming company still has the liability. In a noteworthy change made in response to industry comments, the requirement to capitalize reserve increases only applies in situations when the deemed or actual reinsurance transaction involved a negative ceding commission, and, only to the extent of the negative ceding commission. See Temp. Treas. Reg. section 1.338-11T(d)(6). When capitalization is required, the assuming company will be required to include an amount in gross income to offset the increase in reserve deduction and include the same amount in the basis of assets. The ceding company will not make any adjustments.

Section 847 Estimated Tax Payments on Unpaid Losses Will Disappear—The deemed asset sale by the old target under section 338 will cause its special loss discount account under section 847 to be reduced and the reduction taken into income, except to the extent that the old target actually distributes the lines of insurance business subject to section 847 to an insurer parent. Treas. Reg. sections 1.338-11(h) and 1.381(c)(22) - 1(b)(14). The 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.

Section 846(e) Election Can Continue in a Section 338 Election—The new target is permitted to apply the old target's experience as a result of any section 846(e) election to compute discounted unpaid losses using the company's historical payment patterns. Therefore, after a section 338 election when the old target has a section 846(e) election in effect, the new target can choose to continue to use the historical loss payment pattern of the old target or may revoke the election. Temp. Treas. Reg. section 1.338-11T(e).

Retroactive Elections

The regulations permit an election to apply the final section 338 regulations 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(g) election was made for a foreign target, either the seller or the purchaser can independently choose to apply the regulations retroactively. Treas. Reg. section 1.338(i)-1(c)(2) and (3). In the unusual case when a section 338(g) election was made for a domestic target, both the old and the new target must agree in order to apply the regulations to transactions that occurred prior to April 10. 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. Treas. Reg. section 1.1060-1(a)(2)(i).

Conclusion

The regulations provide long-awaited guidance on issues that sellers and buyers of insurance companies and blocks of insurance need certainty. Having definite rules will assist the parties negotiating the purchase price or ceding commission by tending to prevent claims by one side or the other of uncertain tax results. Although very instructive and even helpful in providing guidance on many open issues, the new regulations are deficient in not defining more clearly when actual reinsurance is subject to the new rules instead of the old regulations. Perhaps this gap in guidance will be filled by taxpayers seeking private letter rulings or by other forms of guidance.

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