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Proposed Regulations on Ownership Change Present Issues for Insurance Companies

By Samuel A. Mitchell and Arthur C. Schneider

Editor's note: The following article is the first in a new series about taxation for mergers and acquisitions and reinsurance. Look for our next installment to learn more from a product tax perspective in a future issue of TAXING TIMES.

In September 2019, the U.S. Department of the Treasury (Treasury) and the Internal Revenue Service (IRS) issued proposed regulations under Internal Revenue Code (IRC) § 382(h) regarding items of income and deduction included in the calculation of built-in gains and losses for the purpose of applying IRC § 382 limitations.¹ The proposed regulations in their current form present serious problems for mergers and acquisitions of insurance companies that have been described to the IRS in comment letters.² This article is intended to give a top-level overview of IRC § 382(h) and to highlight some potential problems the proposed regulations present for acquisitions of insurance companies with unused tax losses and deductions as outlined by the industry to the IRS.

OVERVIEW OF IRC § 382(h)

IRC § 382 in general limits the use of a loss corporation's prechange-in-ownership losses in postchange periods to an annual amount equal to the value of the loss corporation multiplied by the long-term tax-exempt rate (1.63 percent as of March 2020).³ The idea underlying the limitation is to prevent corporations from trafficking in net operating losses and built-in losses by placing a limit on the amount of postchange income that can be offset by prechange losses. The limits are intended to ensure that tax reductions from existing losses are not worth more for the acquiring company than they would be for the loss corporation were it not for the ownership change.⁴



A change in ownership for this purpose generally occurs when one or more “5-percent” shareholders as of a testing date increases their ownership in a loss corporation by 50 percentage points over their lowest percentage ownership during a testing period.⁵ A loss corporation generally refers to one that, immediately before the change in ownership, has carryovers of net operating losses or that has a net operating loss during the year in which the change in ownership occurs.⁶ The term also includes a corporation that has a built-in loss.⁷ The limitation applies on a permanent basis to prechange losses, and for a five-year recognition period for built-in losses.⁸

A guiding principle for § 382 is the “neutrality” principle.⁹ According to this principle, a loss corporation's built-in gains and losses, when recognized after an ownership change takes place, should be treated in the same way that the gains or losses would have been treated were it not for the ownership change. In furtherance of the neutrality principle, IRC § 382(h) provides rules covering built-in gains or losses in existence immediately before the ownership change that are recognized during the five-year period after the ownership change, known as the “recognition period.”¹⁰ These rules involve an alphabet soup of concepts defining the status of gains and losses, including NUBIL, NUBIG, RBIL and RBIG, as described next.

In short, if a loss corporation has net unrealized built-in loss (NUBIL) immediately before the ownership change, its recognized built-in loss (RBIL) during the recognition period is considered to be attributable to prechange periods and therefore is subject to the IRC § 382 limitation to the extent of NUBIL as reduced by RBIL recognized earlier during the recognition period. In other words, the losses that were determined to be built up

as an economic matter in pre-ownership-change years are limited if recognized in the five-year period after the ownership change.

In the case of a loss corporation that is in a net unrealized built-in gain (NUBIG) position immediately before the ownership change, its limitation during the recognition period is increased by recognized built-in gain (RBIG) capped by the NUBIG as reduced by RBIG previously recognized during the recognition period. In this case, the neutrality principle dictates that the limit is increased so that gains realized in the recognition period that were built up before the ownership change are treated the same as if no ownership change had occurred.

Thus, for a loss corporation in a NUBIL position, RBIL increases the losses subject to the § 382 limitation, while for a loss corporation in a NUBIG position, RBIG increases the amount of the limitation. The importance of RBIL and RBIG is magnified by the extremely low level of the § 382 interest rate that limits post-acquisition loss utilizations.

The idea underlying the limitation is to prevent corporations from trafficking in net operating losses and built-in losses by placing a limit on the amount of postchange income that can be offset by prechange losses.

The NUBIG/NUBIL amount, in general, is measured by the difference between the fair market value of the corporation's assets and the aggregate adjusted basis of its assets immediately before the ownership change.¹¹ The NUBIG/NUBIL amounts are adjusted for amounts determined as of the ownership change date that would be considered RBIG or RBIL if such amounts were recognized during the recognition period, regardless of whether they are recognized in that five-year period.¹² RBIG and RBIL generally refer to any gain or loss recognized on disposition of an asset during the recognition period to the extent of the difference between the fair market value of the asset and its adjusted basis immediately before the ownership change.¹³ In furtherance of the neutrality principle discussed earlier, RBIG also includes any item of income properly taken into account in the recognition period that is "attributable to" periods before the change in ownership, and RBIL includes any amount of deduction allowable during the recognition period (without regard

to carryover) that is "attributable to" periods before the change in ownership.¹⁴

NOTICE 2003-65

The inclusion by IRC § 382(h)(6) of items of income and deduction in the recognition period that are "attributable to" prechange periods in RBIG and RBIL was a source of uncertainty for taxpayers until the IRS issued Notice 2003-65.¹⁵ The notice allows taxpayers to rely on a hypothetical sale model for determining NUBIG and NUBIL that includes two alternative safe harbor approaches for determining the amounts of built-in items that are "attributable to" prechange periods. In both approaches, the loss corporation is treated as having sold all of its assets, including goodwill, at fair market value to a third party that assumed all of its liabilities.

The two safe harbors are based on rules developed under other IRC sections. The first safe harbor is the IRC § 1374 approach. The rules and regulations under IRC § 1374 generally apply accrual accounting to determine built-in items. Under this approach, items of income and deduction that are considered to have been accrued for tax purposes in prechange periods are considered built-in items.

The second safe harbor is the IRC § 338 approach. IRC § 338 permits a purchasing corporation to make an election to treat a stock purchase as a purchase of the acquired corporation's assets whereby the target corporation is treated as having sold its assets at fair market value as of the closing of the transaction and is treated as a new corporation that purchased the assets. The IRC § 338 approach described in Notice 2003-65 is based on a comparison of actual items of income, deduction, gain and loss against the items that would have been realized if the loss corporation had made an IRC § 338 election in a hypothetical sale of all its stock on the date of the ownership change.

The notice explains that the results may substantially differ under the two safe harbor approaches. Specifically, the IRC § 338 approach allows built-in gain assets to generate RBIG even if they are not disposed of during the recognition period. The approach generates RBIG to the extent of the excess of a hypothetical cost recovery deduction on a built-in gain asset if an election had been made, over the actual allowable cost recovery deduction. For this reason, practitioners generally have considered the IRC § 338 safe harbor to be more favorable to taxpayers in a NUBIG position, and particularly those that have valuable intangible assets.¹⁶ The notice also explains that the IRC § 338 approach provides that contingent liabilities that exist as of the change date may be treated as RBIL. For this reason, the IRC § 1374 approach, which does not consider contingent items under the notice approach, may be preferable for loss corporations in a NUBIL position.

THE PROPOSED REGULATIONS

The proposed regulations would require use of the IRC § 1374 safe harbor computation provided in Notice 2003-65, with certain modifications that generally are unfavorable to taxpayers and would altogether eliminate the IRC § 338 approach. One important modification to the IRC § 1374 approach is a requirement to value contingent liabilities at the change date for treatment as a built-in item. As mentioned, contingent items were not considered under the IRC § 1374 approach under the notice. The preamble to the proposed regulations explains that Treasury and the IRS concluded that, of the two safe harbors provided in Notice 2003-65, the IRC § 1374 approach is more consistent with the text and purpose of IRC § 382 than the IRC § 338 approach. The preamble points out that, under the IRC § 338 approach, depreciation deductions on certain built-in gain assets can create RBIG even though no actual recognition of gain or loss occurs during the recognition period. The preamble viewed this result as inconsistent with the language of the statute. Furthermore, the preamble explained that changes in the Tax Cuts and Jobs Act led Treasury and the IRS to conclude that the hypothetical cost recovery deductions under the IRC § 338 approach do not provide a reasonable estimate of the income or deduction a built-in gain or loss asset would produce during the recognition period.

As indicated, the IRC § 1374 approach adopted in the proposed regulations identifies RBIG and RBIL at the time of the disposition of a loss corporation's assets during the recognition period. To implement this approach, the proposed regulations generally provide that NUBIG (positive) or NUBIL (negative) is:

- the amount equal to the amount realized if, immediately before the ownership change, the loss corporation sold all of its assets, including goodwill and other intangibles, at fair market value¹⁷ to an unrelated third party with the *hypothetical buyer assuming no liabilities* (after satisfaction of any inadequately secured nonrecourse liabilities);
- reduced by the loss corporation's aggregate adjusted basis of the § 382 assets, the amount of any noncontingent liability that could be deducted on payment of the liability, and the estimated value of any contingent liability immediately before the ownership change that could be deducted on payment or accrual upon the removal of the contingency;
- increased or decreased by any IRC § 481 adjustments (*i.e.*, timing adjustments for changes in method of accounting) taken into account on the sale; and
- increased by the amount of potential RBIG if all amounts were properly taken into account during the five-year recognition period and decreased by the amount of potential RBIL using the same assumption.

RBIL can occur as a result of certain cost recovery (*e.g.*, depreciation or amortization) deductions and deductions for noncontingent liabilities deductible on payment of the liability or for



contingent liabilities deductible on removal of the contingency during the five-year recognition period, but not for accrued liabilities that are deductible when accrued.

Under the notice safe harbor, contingent liabilities were considered under the IRC § 338 approach only. As for the valuation of contingent liabilities, the proposed regulations provide that the value is the amount reflected on the most current applicable financial statement as of the change date if the liability is reflected on the face of the statement, and it is not adjusted to reflect the actual amount of liability established on removal of the contingency.¹⁸

Taxpayers may continue to rely on either safe harbor approach laid out in Notice 2003-65 until final regulations are issued, but Notice 2003-65 is intended to be withdrawn as of the date the proposed regulations are finalized.

TRANSITION RELIEF

On Jan. 10, 2019, Treasury and the IRS issued transition relief under the proposed regulations. Taxpayers and practitioners had expressed concern that the applicability date of the proposed regulations would impose a significant burden on taxpayers evaluating and negotiating business transactions. With respect to insurance company acquisitions, additional concerns had been expressed relating to (1) regulatory approvals, which add requirements to closing to which unregulated businesses are not subject, and (2) additional complications that could arise in the acquisition of a distressed insurer, depending on the level of control being exercised by state insurance regulatory authorities under laws based on the National Association of Insurance Commissioners Risk-Based Capital (RBC) for Insurers Model Act.

In response, Treasury and the IRS revised a portion of the proposed regulations to delay the applicability date of the final regulations to apply to certain ownership changes that occur after the date that is 30 days after the date the final regulations are published in the Federal Register, and added transition relief provisions for certain types of transactions.

Under the transition relief provisions, final regulations would not apply to certain ownership changes that occur after the delayed applicability date, including those pursuant to a binding agreement in effect on or before the delayed applicability date and at all times thereafter, and those pursuant to a specific transaction described in a public announcement made on or before the delayed applicability date or described in a filing with the Securities and Exchange Commission submitted on or before the delayed applicability date.

Taxpayers may continue to rely on Notice 2003-65, including the IRC § 338 approach, with respect to any ownership change qualifying for transition relief, even though the Notice will be made obsolete on the delayed applicability date. However, taxpayers also may choose to apply the final regulations to such an ownership change.

POTENTIAL ISSUES FOR INSURANCE COMPANIES

The proposed regulations do not specifically address how changes in ownership in the insurance company context are to be treated, and there is considerable uncertainty on how the regulations might apply. The potential issues, as well as comments that were made in response by the ACLI and by the property and casualty insurance industry, are summarized in the following paragraphs.

Insurance-in-Force

Perhaps the most critical issue for insurance companies is the treatment of an insurer's intangible asset stemming from its existing contractual relationships—often referred to as value of insurance-in-force (VIF).¹⁹ In determining NUBIG/NUBIL, the proposed regulations depart from the approach in Notice 2003-65 by assuming a hypothetical sale of assets in which the buyer assumes no liabilities. But that approach is unworkable in the context of the sale of insurance business, where the value of existing insurance contracts derives from the assumption of contractual liabilities. One solution to this problem would be for the regulations to carve out an exception for ownership changes involving insurance companies to allow the hypothetical sale of insurance contracts to involve an assumption of liabilities. Alternatively, the regulations could return to the model set forth in Notice 2003-65 where the hypothetical sale did involve assumption of all of the liabilities of the loss corporation. Without one of these changes, the regulations simply would be impossible to apply to an insurance business.

Policy Reserves

The comment letters described two aspects of insurance reserves relevant to the determinations required by the proposed regulations. First, reserves are an element of VIF, which generally is determined as the present value of future distributable earnings determined on a regulatory basis. In other Treasury regulations involving sales or ac-

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quisitions of insurance contracts, Treasury and the IRS have already made it clear that tax reserves are the proper measure of the liability. For example, tax reserves are used in determining the purchase price in the deemed asset acquisition that results when a purchase of stock is treated as a purchase of assets pursuant to an election under IRC § 338.²⁰ The same is true for determining taxable income in a reinsurance transaction.²¹ Similarly, under IRC §§ 197 and 1060, the amount paid for insurance-in-force is determined by reference to tax reserves.²² Accordingly, the comment letters conclude, tax reserves should likewise be treated as the proper measure for the calculations required under § 382(h) and the proposed regulations.

The second aspect of tax reserves addressed in the comment letters is that reserves reflect prechange economic activity and should not be treated as built-in items. As noted previously, the proposed regulations provide that NUBIG/NUBIL is reduced by the amount of any noncontingent liability of the loss corporation that could be deducted on payment of the liability, and by the estimated value of any contingent liability immediately before the ownership change that could be deducted on payment or accrual upon the removal of the contingency. Accordingly, RBIL can occur as a result of deductions for such noncontingent or contingent liabilities during the five-year recognition period. However, for insurance companies, the tax law allows reserves to be deducted and specifies how deductible reserves are to be computed. In that sense, reserves are treated for insurance companies as accrued liabilities are for other taxpayers, even though they are amounts set aside to pay future unaccrued claims. Accordingly, the comment letters request that the regulations clarify that insurance tax reserves should not be treated either as a noncontingent liability that could be deducted on payment of the liability or as a contingent liability that could be deducted on the removal of the contingency.

The Neutrality Principle

Another area of concern with the proposed regulations expressed in insurance industry comment letters is the apparent disregard of the neutrality principle resulting from the regulations' elimination of Notice 2003-65's allowance of hypothetical cost recovery deductions under the IRC § 338 approach as an estimate of the income a built-in gain asset would produce during the recognition period. This change in the proposed regulations would adversely impact loss corporations with NUBIG attributable in part to valuable intangible assets, like VIF. Many comment letters

objecting to this change were submitted by companies and industry trade groups across the broad spectrum of corporate America.

In the absence of an acquisition, a “wasting” intangible asset, like VIF, would produce income that could absorb the loss attributes of a loss corporation. The IRC § 338 approach under Notice 2003-65 had recognized this prechange aspect of a valuable intangible and allowed cost recovery deductions as an estimate of the postchange recognition period income produced by the intangible, which, admittedly, would be difficult or impossible to measure directly. As noted, the IRS and Treasury have concerns that using cost recovery deductions may produce an unreasonable estimate of income during the recognition period, but by eliminating this approach, the proposed regulations have gone to the other extreme of not permitting RBIG treatment when built-in gain is recognized by the loss corporation without an actual disposition of the asset.

CONCLUSION

The proposed regulations have attracted many comment letters from companies in a wide variety of industries. The IRS and Treasury are required to give careful consideration to all comments filed before the November 2019 comment deadline. Some of the insurance industry’s concerns are truly unique to the insurance business, and it is hoped that the IRS and Treasury adopt changes to address those concerns when final regulations are published. ■

This article is intended to summarize issues and problems in the regulation and is not intended as a comprehensive discussion of IRC § 382 or its application to insurance companies.

Samuel A. Mitchell is a partner with the Washington, DC, law firm of Scribner, Hall & Thompson LLP and may be reached at smitchell@scribnerhall.com.

Arthur C. Schneider is a consultant for the American Council of Life Insurers and may be reached at artschneider7661@gmail.com.

ENDNOTES

- 1 REG-125710-18.
- 2 Among the many comment letters filed in response to the proposed regulations, the ACLI filed a letter dated Nov. 11, 2019, on behalf of the life insurance industry; three property and casualty insurance trade groups (American Property Casualty Insurance Association, National Association of Mutual Insurance Companies, and Reinsurance Association of America) filed a letter dated Nov. 12, 2019; and Scribner, Hall & Thompson attorneys filed a letter dated Nov. 8, 2019, on behalf of a group of property and casualty insurance companies.
- 3 IRC § 382(b)(1). There are very detailed rules in IRC § 382 and the regulations defining an ownership change and defining the limitations and exceptions to the limitations with respect to loss corporations that undergo an ownership change. A full discussion of these rules is beyond the scope of this article.
- 4 See S. Rep. No. 99-313, at 235 (1986); H.R. Rep. No. 99-426 (1986). See also Comment Letter from the American Bar Association Section of Taxation regarding the Proposed Regulations under Section 382(h) (Nov. 12, 2019), for a full discussion of the policy underlying the section.
- 5 IRC § 382(g).
- 6 IRC § 382(k).
- 7 *Id.*
- 8 IRC § 382(a), (h).
- 9 Notice of Proposed Rulemaking, 84 Fed. Reg. 47455, 47459 (Sept. 10, 2019).
- 10 IRC § 382(h)(7).
- 11 IRC § 382(h)(3). Note that NUBIG and NUBIL are subject to a threshold amount that generally is equal to the lesser of 15 percent of the fair market value of the corporation’s assets or \$10 million. If the net built-in gain or loss is not above the threshold, the NUBIG/NUBIL amount is zero. IRC § 382(h)(3)(B).
- 12 IRC § 382(h)(6)(C).
- 13 IRC § 382(h)(2)(A) and (B).
- 14 IRC § 382(h)(6).
- 15 Notice 2003-65, 2003-2 C.B. 747.
- 16 This point was explained in a comprehensive comment letter filed by the American Bar Association Section of Taxation (Nov. 12, 2019) in response to the proposed regulations. (See letter, page 19.)
- 17 The proposed regulations take the position that the fair market value that is accounted for in the calculation can be capped by IRC § 382(h)(8).
- 18 Prop. Reg. § 1.382-7(c)(3)(iii).
- 19 VIF is also sometimes referred to as value of business acquired (VOBA). For short-term accident and health and property and casualty lines of business, VIF can include the expectation of contract renewals. Other valuable insurance intangibles may include the assets that make up an insurance company’s marketing infrastructure.
- 20 Treas. Reg. § 1.338-11(b).
- 21 Treas. Reg. § 1.817-4(d).
- 22 Treas. Reg. §§ 1.197-2(g)(5), 1.1060-1(c)(5).