§ 1.338–11 Effect of section 338 election on insurance company targets.

(a) In general. This section provides rules that apply when an election under section 338 is made for a target that is an insurance company. The rules in this section apply in addition to those generally applicable upon the making of an election under section 338. In the case of a conflict between the provisions of this section and other provisions of the Internal Revenue Code or regulations, the rules set forth in this section determine the Federal income tax treatment of the parties and the transaction when a section 338 election is made for an insurance company target.

(b) Computation of ADSP and AGUB—(1) Reserves taken into account as a liability. Old target’s tax reserves are the reserves for Federal income tax purposes for any insurance, annuity, and reinsurance contracts deemed sold by old target to new target in the deemed asset sale. The amount of old target’s tax reserves is the amount that is properly taken into account by old target for the contracts at the close of the taxable year that includes the deemed sale tax consequences (before giving effect to the deemed asset sale and assumption reinsurance transaction). Old target’s tax reserves are a liability of old target taken into account in determining ADSP under §1.338–4 and a liability of new target taken into account in determining AGUB under §1.338–5.

(2) Allocation of ADSP and AGUB to specific insurance contracts. For purposes of allocating AGUB and ADSP under §§1.338–6 and 1.338–7, the fair market value of a specific insurance, reinsurance or annuity contract or group of insurance, reinsurance or annuity contracts (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. See §1.197–2(g)(5) for rules concerning the treatment of the amount allocable to insurance contracts acquired in the deemed asset sale.

(c) Application of assumption reinsurance principles—(1) In general. If a target is an insurance company, the deemed sale of insurance contracts is treated for Federal income tax purposes as an assumption reinsurance transaction between old target, as the reinsured or ceding company, and new target, as the reinsurer or acquiring company, at the close of the acquisition date. The Federal income tax treatment of the assumption reinsurance transaction is determined under the applicable provisions of subchapter L, chapter 1, subtitle A of the Internal Revenue Code, as modified by the rules set forth in this section.

(2) Reinsurance premium. Old target is deemed to pay a gross amount of premium in the assumption reinsurance transaction equal to the amount of old target’s tax reserves for the insurance contracts that are acquisition date assets (acquired contracts). New target is
deemed to receive a reinsurance premium in the amount of old target’s tax reserves for the acquired contracts. See paragraph (d) of this section for circumstances in which new target is deemed to receive additional premium. See §1.817–4(d)(2) for old target’s and new target’s treatment of the premium.

(3) Ceding commission. Old target is deemed to receive a ceding commission in an amount equal to the amount of ADSP allocated to the acquired contracts, as determined under §§1.338–6 and 1.338–7 and paragraph (b) of this section. New target is deemed to pay a ceding commission in an amount equal to the amount of AGUB allocated to the acquired contracts, as determined under §§1.338–6 and 1.338–7 and paragraph (b) of this section. See §1.817–4(d)(2) for old target’s and new target’s treatment of the ceding commission.

(4) Examples. The following examples illustrate this paragraph (c):

Example 1. (i) Facts. On January 1, 2003, T, an insurance company, has the following assets with the following fair market values: $10 cash, $30 of securities, $10 of equipment, a life insurance contract having a value, under paragraph (b)(2) of this section, of $37, and goodwill and going concern value. T has tax reserves of $50 and no other liabilities. On January 1, 2003, P purchases all of the stock of T for $16 and makes a section 338 election for T. For purposes of the capitalization requirements of section 848, assume new T has $20 of general deductions in its first taxable year ending on December 31, 2003, and earns no other premiums during the year.

(ii) Analysis. (A) For Federal income tax purposes, the section 338 election results in a deemed sale of the assets of old T to new T. Old T’s ADSP is $66 ($16 amount realized for the T stock plus $50 liabilities). New T’s AGUB also is $66 ($16 basis for the T stock plus $50 liabilities). See paragraph (b)(1) of this section. Each of the AGUB and ADSP is allocated under the residual method of §§1.338–6 to determine the purchase or sale price of each asset transferred. Each of the AGUB and ADSP is allocated as follows: $10 to cash (Class I), $30 to the securities (Class II), $10 to equipment (Class V), $16 to the life insurance contract (Class VI), and $0 to goodwill and going concern value (Class VII).

(B) Under section 381, old T’s amount realized for the securities is $30 and for the equipment is $10. As a result of the deemed asset sale, there is an assumption reinsurance transaction between old T (as ceding company) and new T (as reinsurer) at the close of the acquisition date for the life insurance contract issued by old T. See paragraph (c)(1) of this section. Although the assumption reinsurance transaction results in a $50 decrease in old T’s reserves, which is taxable income to old T, the reinsurance premium paid by old T is deductible by old T. Under paragraph (c)(2) of this section, old T is deemed to pay a reinsurance premium equal to the reserve for the life insurance contract immediately before the deemed asset sale ($50) and is deemed to receive a ceding commission from new T. Under paragraph (c)(3) of this section, the portion of the ADSP allocated to the life insurance contract is $16; thus, the ceding commission is $16. Old T, therefore, is deemed to pay new T a reinsurance premium of $34 ($50 – $16 = $34). Old T also has $34 of net negative consideration for purposes of section 848. See paragraph (f) of this section for rules relating to the effect of a section 338 election on the capitalization of amounts under section 848.

(C) New T obtains an initial basis of $30 in the securities and $10 in the equipment. New T is deemed to receive a reinsurance premium from old T in an amount equal to the $50 of reserves for the life insurance contract and to pay old T a $16 ceding commission for the contract. See paragraphs (c)(2) and (3) of this section. Accordingly, new T includes $50 of premium in income and deducts $50 for its increase in reserves. For purposes of section 848, new T has $34 of net positive consideration for the deemed assumption reinsurance transaction. Because the only contract involved in the deemed assumption reinsurance transaction is a life insurance contract, new T must capitalize $2.62 ($34 × 7.7% = $2.62) under section 848. New T will amortize the $2.62 as provided under section 848. New T’s adjusted basis in the life insurance contract, which is an amortizable section 197 intangible, is $13.38, the excess of the $16 ceding commission over the $2.62 capitalized under section 848. See section 197 and §1.197–2(g)(5). New T deducts the $2.62 of the ceding commission that is not amortizable under section 197 because it is reflected in the amount capitalized under section 848 and also deducts the remaining $17.38 of its general deductions.

Example 2. (i) Facts. Assume the same facts as in Example 1, except the life insurance contract has a value of $0 and the fair market value of T’s securities are $60. Thus, to reinsure the contract in an arm’s length transaction, T would have to pay the reinsurer a reinsurance premium in excess of T’s $50 of tax reserves for the contract.

(ii) Analysis. (A) For Federal income tax purposes, the section 338 election results in a deemed sale of the assets of old T to new T. Old T’s ADSP is $66 ($16 amount realized for the T stock plus $50 liabilities). New T’s AGUB also is $66 ($16 basis for the T stock
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plus $50 liabilities). See paragraph (b)(1) of this section. Each of the AGUB and ADSP is allocated under the residual method of §1.338–6 to determine the purchase or sale price of the asset transferred. Each of the AGUB and ADSP is allocated as follows: $10 to cash (Class I), $56 to the securities (Class II), $0 to the equipment (Class V), $0 to the life insurance contract (Class VI), $0 to goodwill and going concern value (Class VII).

(B) Under section 1001, old T’s amount realized for the securities is $56 and for the equipment is $0. As a result of the deemed asset sale, there is an assumption reinsurance transaction between old T (as ceding company) and new T (as reinsurer) at the close of the acquisition date for the life insurance contract issued by old T. See paragraph (c)(1) of this section. Although the assumption reinsurance transaction results in a $50 decrease in old T’s reserves, which is taxable income to old T, the reinsurance premium deemed paid by old T to new T is deductible by old T. Under paragraph (c)(2) of this section, old T is deemed to pay a reinsurance premium equal to the reserve for the life insurance contract immediately before the deemed asset sale ($50), and is deemed to receive from new T a ceding commission equal to the amount of AGUB allocated to the life insurance contract ($0), as provided in paragraph (c)(3) of this section. Old T also has $50 of net negative consideration for purposes of section 848. See paragraph (f) of this section for rules relating to the effect of a section 338 election on capitalization amounts under section 848.

(C) New T obtains an initial basis of $56 in the securities (with a fair market value of $60) and $0 in the equipment (with a fair market value of $10). New T is deemed to receive a reinsurance premium from old T in an amount equal to the $50 of reserves for the life insurance contract. Accordingly, new T includes $50 of premium in income and deducts $50 for its increase in reserves. For purposes of section 848, new T has $50 of net positive consideration for the deemed assumption reinsurance transaction. Because the only contract involved in the assumption reinsurance transaction is a life insurance contract, new T must capitalize $3.85 ($50 × 7.7%) under section 848 from the transaction and deducts the remaining $16.15 of its general deductions. Because new T allocates $0 of the AGUB to the insurance contract, no amount is amortizable under section 197 with respect to the insurance contract. See §1.338–11T(d) for rules on adjustments required if new T increases its reserves for, or reinsurance at a loss, the acquired life insurance contract.

(d) Reserve increases by new target after the deemed asset sale—(1) In general. If in new target’s first taxable year or any subsequent year, new target increases its reserves for any acquired contracts, new target is treated as receiving an additional premium, which is computed under paragraph (d)(3) of this section, in the assumption reinsurance transaction described in paragraph (c)(1) of this section. New target includes the additional premium in gross income for the taxable year in which new target increases its reserves for acquired contracts. New target’s increase in reserves for the insurance contracts acquired in the deemed asset sale is a liability of new target not originally taken into account in determining AGUB that is subsequently taken into account. Thus, AGUB is increased by the amount of the additional premium included in new target’s gross income. See §§1.338–5(b)(2)(i) and 1.338–7. Old target has no deduction under this paragraph (d) and makes no adjustments under §§1.338–4(b)(2)(i) and 1.338–7.

(2) Exceptions. New target is not treated as receiving additional premium under paragraph (d)(1) of this section if—

(i) It is under state receivership as of the close of the taxable year for which the increase in reserves occurs; or

(ii) It is required by section 807(f) to spread the reserve increase over the 10 succeeding taxable years.

(3) Amount of additional premium—(i) In general. The additional premium taken into account under this paragraph (d) is an amount equal to the sum of the positive amounts described in paragraphs (d)(3)(ii) and (d)(3)(iii) of this section. However, the additional premium cannot exceed the limitation described in paragraph (d)(4) of this section.

(ii) Increases in unpaid loss reserves. The positive amount with respect to unpaid loss reserves is computed using the formula A/B × (C – [D + E]) where—

(A) A equals old target’s discounted unpaid losses (determined under section 846) included in AGUB under paragraph 11(b)(1) of this section;

(B) B equals old target’s undiscounted unpaid losses (determined under section 846(b)(1)) as of the close of the acquisition date;

(C) C equals new target’s undiscounted unpaid losses (determined under section 846(b)(1)) at the
end of the taxable year that are attributable to losses incurred by old target on or before the acquisition date;

(D) D (which may be a negative number) equals old target’s undiscounted unpaid losses as of the close of the acquisition date, reduced by the cumulative amount of losses, loss adjustment expenses, and reinsurance premiums paid by new target through the end of the taxable year for losses incurred by old target on or before the acquisition date; and

(E) E equals the amount obtained by dividing the cumulative amount of reserve increases taken into account under this paragraph (d) in prior taxable years by A/B.

(iii) Increases in other reserves. The positive amount with respect to reserves other than discounted unpaid loss reserves is the net increase of those reserves due to changes in estimate, methodology, or other assumptions used to compute the reserves (including the adoption by new target of a methodology or assumptions different from those used by old target).

(4) Limitation on additional premium. The additional premium taken into account by new target under paragraph (d)(1) of this section is limited to the excess, if any, of—

(i) The fair market value of old target’s assets acquired by new target in the deemed asset sale (other than Class VI and Class VII assets); over

(ii) The AGUB allocated to those assets (including increases in AGUB allocated to those assets as the result of reserve increases by new target in prior taxable years).

(5) Treatment of additional premium under section 848. If a portion of the positive amounts described in paragraphs (d)(3)(i) and (iii) of this section are attributable to an increase in reserves for specified insurance contracts (as defined in section 848(e)), new target takes an allocable portion of the additional premium in determining its specified policy acquisition expenses under section 848(c) for the taxable year of the reserve increase.

(6) Examples. The following examples illustrate this paragraph (d):

Example 1. (i) Facts. On January 1, 2006, P purchases all of the stock of T, a non-life insurance company, for $120 and makes a section 338 election for T. On the acquisition date, old T has total reserve liabilities under state law of $725, consisting of undiscounted unpaid losses of $625 and unearned premiums of $100. Old T’s tax reserves on the acquisition date are $580, which consist of discounted unpaid losses (as defined in section 846) of $500 and unearned premiums (as computed under section 832(b)(4)(B)) of $60. Old T has Class I through Class V assets with a fair market value of $800. Old T also has a Class VI asset with a fair market value of $75, consisting of the future profit stream of certain insurance contracts. During 2006, new T makes loss and loss adjustment expense payments of $200 with respect to the unpaid losses incurred by old T before the acquisition date. As of December 31, 2006, new T reports undiscounted unpaid losses of $475 attributable to losses incurred before the acquisition date. The related amount of discounted unpaid losses (as defined in section 846) for those losses is $390.

(ii) Computation and allocation of AGUB. Under §1.338-5 and paragraph (b)(1) of this section, as of the acquisition date, AGUB is $700, reflecting the sum of the amount paid for old T’s stock ($120) and the tax reserves assumed by new T in the transaction ($580). The fair market value of old T’s Class I through V assets is $800, whereas the AGUB available for such assets under §1.338-6 is $700. There is no AGUB available for old T’s Class VI assets, even though such assets have a fair market value of $75 on the acquisition date.

(iii) Adjustments for increases in reserves for unpaid losses. Under paragraph (d) of this section, new T must determine whether there are any amounts by which it increased its unpaid loss reserves that will be treated as an additional premium and an increase in AGUB. New T applies the formula of paragraph (d)(3) of this section, where A equals $500, B equals $625, C equals $745, D equals $425 ($525 – $200), and E equals $0. Under this formula, new T is treated as having increased its reserves for discounted unpaid losses attributable to losses incurred by old T by $40 ($500/625 × ($475 – ($425 + 0))). The limitation under paragraph (d)(5) of this section based on the difference between the fair market value of old T’s Class I through Class V assets and the AGUB allocated to such assets is $100. Accordingly, new T includes an additional premium of $40 in gross income for 2006, and increases the AGUB allocated to old T’s Class I through Class V assets to reflect this additional premium.

Example 2. (i) Facts. Assume the same facts as in Example 1. Further assume that during 2007 new T deducts total loss and loss expense payments of $375 with respect to losses incurred by old T before the acquisition date. On December 31, 2007, new T reports
undiscounted unpaid losses of $150 with respect to losses incurred before the acquisition date. The related amount of discounted unpaid losses (as defined in section 846) for these unpaid losses is $125.

(ii) Analysis. New T must determine whether any amounts by which it increased its unpaid losses during 2007 will be treated as an additional premium under paragraph (d) of this section. New T applies the formula under paragraph (d)(3) of this section, where A equals $500, B equals $625, C equals $150, D equals $100 with respect to losses incurred by old T before the acquisition date ($500/$625 − $575), and E equals $50 ($10 divided by .8). In paragraph (d)(3) of this section, new T treats as increasing its reserves for undiscounted unpaid losses by $40 during 2007 with respect to losses incurred by old T ($500/$625 × ($150 − ($50 + $50))). New T determines the limitation of paragraph (d)(5) of this section by comparing the $800 fair market value of the Class I through V assets acquired from old T before the acquisition date to the $740 AGUB allocated to such assets (which includes the $40 addition to AGUB included during 2006). Thus, new T recognizes $40 of additional premium as a result of the increase in reserves during 2007, and adjusts the AGUB allocable to the Class I through V assets acquired from old T to reflect such additional premium.

Example 3. (i) Facts. The facts are the same as Example 2, except that on January 1, 2008, new T reinsures the outstanding liability with respect to losses incurred by old T before the acquisition date through a portfolio reinsurance transaction with R, another non-life insurance company. R agrees to assume any remaining liability relating to losses incurred by old T before the acquisition date in exchange for a reinsurance premium of $200. Accordingly, as of December 31, 2008, new T reports no undiscounted unpaid losses with respect to losses incurred by old T before the acquisition date.

(ii) Analysis. New T must determine whether any amount by which it increased its unpaid loss reserves will be treated as an additional premium under paragraph (d) of this section. New T applies the formula under paragraph (d)(3) of this section, where A equals $500, B equals $625, C equals $150, D equals $100 with respect to losses incurred by old T before the acquisition date ($500/$625 − $575), and E equals $50 ($10 divided by .8). Thus, new T treats as having increased its discounted unpaid losses by $40 during 2008 with respect to losses incurred by old T before the acquisition date ($500/$625 × $0 − $150 + $100)). New T includes this positive amount in gross income, subject to the limitation of paragraph (d)(4) of this section. The limitation of paragraph (d)(4) of this section equals $20, which is computed by comparing the $800 fair market value of the Class I through V assets acquired from old T with the $780 AGUB allocated to such assets (which includes the $40 addition to AGUB in 2006 and the $40 addition to AGUB in 2007). Thus, New T includes $20 in additional premium, and increases the AGUB allocated to the Class I through V assets acquired from old T by $20. As a result of these adjustments, the limitation under paragraph (d)(4) of this section is reduced to zero.

(7) Effective/applicability date—(1) In general. This section applies to increases to reserves made by new target after a deemed asset sale occurring on or after April 10, 2006.

(ii) Application to pre-effective date increases to reserves. If either new target makes an election under §1.338(1)(1)(c)(2) or old target makes an election under §1.338(1)(1)(c)(3) to apply the rules of this section, in whole, to a qualified stock purchase occurring before April 10, 2006, then the rules contained in this section shall apply in whole to the qualified stock purchase.

(e) Effect of section 338 election on section 846(e) election—(1) In general. New target and old target are treated as the same corporation for purposes of an election by old target to use its historical loss payment pattern under section 846(e). See §1.338(1)(b)(2)(vii). Therefore, if old target has a section 846(e) election in effect on the acquisition date, new target will continue to use the historical loss payment pattern of old target to discount unpaid losses incurred in accident years covered by the election, unless new target elects to revoke the section 846(e) election. In addition, new target may consider old target’s historical loss payment pattern when determining whether to make the section 846(e) election for a determination year that includes or is subsequent to the acquisition date.

(2) Revocation of existing section 846(e) election. New target may revoke old target’s section 846(e) election to use its historical loss payment pattern to discount unpaid losses. If new target elects to revoke old target’s section 846(e) election, new target will use the industry-wide patterns determined by the Secretary to discount unpaid losses incurred in accident years beginning on or after the acquisition date through the subsequent determination year. New target may revoke old target’s section 846(e) election by attaching a statement to new target’s original tax return for its first taxable year.
(f) Effect of section 338 election on old target’s capitalization amounts under section 848—(1) Determination of net consideration for specified insurance contracts. For purposes of applying section 848 and §1.848–2(f) to the deemed assumption reinsurance transaction, old target’s net consideration (either positive or negative) for each category of specified insurance contracts is an amount equal to—

(i) The allocable portion of the ceding commission (if any) relating to contracts in that category; less

(ii) The amount by which old target’s tax reserves for contracts in that category has been reduced as a result of the deemed assumption reinsurance transaction.

(2) Determination of capitalization amount. Except as provided in §1.381(c)(22)–1(b)(13)—

(i) If, after the deemed asset sale, old target has an amount otherwise required to be capitalized under section 848 for the taxable year or an unamortized balance of specified policy acquisition expenses from prior taxable years, then old target deducts such remaining amount or unamortized balance as an expense incurred in the taxable year that includes the deemed sale tax consequences; and

(ii) If, after the deemed asset sale, the negative capitalization amount resulting from the reinsurance transaction exceeds the amount that old target can deduct under section 848(f)(1), then old target’s capitalization amount is treated as zero at the close of the taxable year that includes the deemed sale tax consequences.

(3) Section 381 transactions. For transactions described in section 381, see §1.381(c)(22)–1(b)(13).

(g) Effect of section 338 election on policyholders surplus account. Except as specifically provided in §1.381(c)(22)–1(b)(7), the deemed asset sale effects a distribution of old target’s policyholders surplus account to the extent the grossed-up amount realized on the sale to the purchasing corporation of the purchasing corporation’s recently purchased target stock (as defined in §1.338–4(c)) exceeds old target’s shareholders’ surplus account under section 815(c).

(b) Effect of section 338 election on section 847 special estimated tax payments. If old target had elected to claim an additional deduction under section 847 for the taxable year that includes the deemed sale tax consequences or any earlier years, the amount remaining in old target’s special loss discount account under section 847 must be reduced to the extent it relates to contracts transferred to new target and the amount of such reduction must be included in old target’s gross income for the taxable year that includes the deemed sale tax consequences. Old target may apply the balance of its special estimated tax account as a credit against any tax resulting from such inclusion in gross income. Any special estimated tax payments remaining after this credit are voided and, therefore, are not available for credit or refund.

Under section 847(1), new target is permitted to claim a section 847 deduction for losses incurred before the deemed asset sale, subject to the general requirement that new target makes timely special estimated tax payments equal to the tax benefit resulting from this deduction. See §1.381(c)(22)–1(c)(14) regarding the carryover of the special loss discount account attributable to contracts transferred in a section 381 transaction.


§1.338(h)(10)–1 Deemed asset sale and liquidation.

(a) Scope. This section prescribes rules for qualification for a section 338(h)(10) election and for making a section 338(h)(10) election. This section also prescribes the consequences of such election. The rules of this section are in addition to the rules of §§1.338–1 through 1.338–10 and, in appropriate cases, apply instead of the rules of §§1.338–1 through 1.338–10.

(b) Definitions—(1) Consolidated target. A consolidated target is a target that is a member of a consolidated group within the meaning of §1.1502–1(h) on the acquisition date and is not the common parent of the group on that date.

(2) Selling consolidated group. A selling consolidated group is the consolidated