

Part I. Rulings and Decisions Under the Internal Revenue Code of 1986

Section 338.—Certain Stock Purchases Treated as Asset Acquisitions

26 CFR 1.338-11: Effect of section 338 election on insurance company targets.

T.D. 9257

DEPARTMENT OF THE TREASURY Internal Revenue Service 26 CFR Parts 1 and 602

Application of Section 338 to Insurance Companies

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final and temporary regulations.

SUMMARY: This document contains final regulations that apply to a deemed sale or acquisition of an insurance company's assets pursuant to an election under section 338 of the Internal Revenue Code, to a sale or acquisition of an insurance trade or business subject to section 1060, and to the acquisition of insurance contracts through assumption reinsurance. It also contains final regulations under section 381 concerning the effect of certain corporate liquidations and reorganizations on certain tax attributes of insurance companies. This document also contains temporary regulations under 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 text of the temporary regulations also serves as the text of the proposed regulations (REG-146384-05) set forth in the notice of proposed rulemaking on this subject in this issue of the Bulletin. The final and temporary regulations apply to insurance companies.

DATES: *Effective Date:* The final and temporary regulations are effective on April 10, 2006.

Applicability Dates: For dates of applicability of these regulations, see §§1.197-2(g)(5)(iv), 1.338(i)-1(c), and 1.1060-1(a)(2). The applicability of §§1.197-2T(g)(5)(ii), 1.338-11T(d), and 1.338-11T(e) will expire on April 7, 2009.

FOR FURTHER INFORMATION CONTACT: Mark Weiss, (202) 622-7790 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Paperwork Reduction Act

The collection of information in these final regulations was not proposed in the preceding notice of proposed rulemaking. The collection of information has been reviewed in accordance with the Paperwork Reduction Act (44 U.S.C. 3507) and, pending receipt and evaluation of public comments, approved by the Office of Management and Budget under control number 1545-1990.

The collection of information is in §§1.338-11T(e)(2), 1.338(i)-1(c), 1.381(c)(22)-1(c), 1.1060-1(a)(2). This information is required by the IRS to allow an insurance company permission to cease using its historical loss payment pattern and to allow parties to a transaction under section 338, to an applicable asset acquisition under section 1060, or to a distribution or reorganization to which section 381 applies to file a retroactive election to apply these regulations to transactions completed before the effective dates of these regulations. The likely recordkeepers are business or other for-profit institutions.

The estimated burden is as follows:

Estimated total annual reporting and/or recordkeeping burden: 12 hours.

Estimated average annual burden per respondent: 1 hour.

Estimated number of respondents: 12.

Estimated annual frequency of responses: once.

Comments concerning the accuracy of this burden estimate and suggestions for reducing this burden should be sent to the **Office of Management and Budget**, Attn:

Desk Officer for the Department of the Treasury, Office of Information and Regulatory Affairs, Washington DC 20503, with copies to the **Internal Revenue Service**, Attn: IRS Reports Clearance Officer, SE:W:CAR:MP:T:T:SP, Washington, DC 20224. Any such comments should be submitted not later than June 9, 2006.

An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless the collection of information displays a valid control number assigned by the Office of Management and Budget.

Books or records relating to a collection of information must be retained as long as their contents may become material in the administration of any internal revenue law. Generally, tax returns and tax return information are confidential, as required by 26 U.S.C. 6103.

Background and Explanation of Provisions

On March 8, 2002, the IRS and the Department of Treasury published a notice of proposed rulemaking in the **Federal Register** (REG-118861-00, 2002-1 C.B. 651 [67 FR 10640]) (the proposed regulations) that sets forth rules applying to taxable acquisitions and dispositions of insurance businesses, including those that are deemed to occur when an election under section 338 of the Internal Revenue Code (Code) is made.

The proposed regulations generally treat the transfer of insurance or annuity contracts and the assumption of related reserve liabilities that are deemed to occur when an election under section 338 is made consistently with the treatment of assumption reinsurance transactions entered into in the ordinary course of business under §1.817-4(d) (and other provisions of subchapter L of chapter 1, subtitle A of the Code and the regulations promulgated thereunder). The proposed regulations provide similar rules for acquisitions of insurance businesses governed by section 1060, whether effected through assumption or indemnity reinsurance. Thus, in the case of both a deemed and an actual transfer of an insurance business, the proposed

regulations provide that the ceding company (in the case of a section 338 election, old target) is treated as having income in the amount of the reduction in its reserves and having a deduction for the consideration paid for the reinsurer's assumption of those liabilities, and the reinsurer (in the case of a section 338 election, new target) is treated as receiving premium income for its assumption of reserve liabilities and having a deduction for its increase in reserves (the latter usually offsetting in amount the former). The proposed regulations also provide that the consideration allocated to the value of the insurance contracts acquired in the assumption reinsurance transaction is treated as an amount paid by the reinsurer to purchase intangible assets and as ordinary income to the ceding company.

The proposed regulations depart from the rules governing assumption reinsurance transactions effected in the ordinary course of business in some circumstances to account for differences that occur because the assumption reinsurance transaction occurs as part of a larger acquisitive transaction. In an assumption reinsurance transaction effected in the ordinary course of business, the total consideration paid for the transfer of insurance contracts and assumption of related liabilities is known. Furthermore, the rules in §1.817-4(d) assume that the only intangible asset transferred in such an assumption reinsurance transaction is the insurance in force which can then be valued using the residual method. Thus, if premiums and ceding commissions are not separately stated, they can be extrapolated from the known elements with a reasonable degree of accuracy. However, when the assumption reinsurance transaction occurs as part of a larger acquisitive transaction, the total consideration paid by the purchaser is not solely for the acquisition of insurance contracts and the liabilities assumed are not solely for the risk on the insurance contracts. In these circumstances, the extrapolated values would not accurately reflect the amount of the items. Accordingly, the proposed regulations modify the general rules for assumption reinsurance transactions to account for these differences.

Written comments were received in response to the proposed regulations, and a public hearing was held on September 18, 2002. Two commentators requested to

speak at the hearing. After consideration of all the comments, the proposed regulations are adopted as amended by this Treasury decision. In general, the final regulations follow the approach of the proposed regulations with some revisions. The more significant comments and revisions are discussed in the order in which they appear in the regulations. In addition to the revisions discussed, the final regulations revise the language of the proposed regulations in some places to clarify the intent of the IRS and Treasury Department or to make the regulations better conform to the terminology and usage of the general section 338 regulations.

A. Determination of Adjusted Basis of Amortizable Section 197 Intangibles with Respect to Insurance Contracts under Section 197(f)(5)

Section 197(f)(5) provides that, in the case of any amortizable section 197 intangible resulting from an assumption reinsurance transaction, the amount taken into account as the adjusted basis of such intangible is the excess of (A) the amount paid or incurred by the acquirer under the assumption reinsurance transaction over (B) the amount required to be capitalized under section 848 in connection with the transaction. Under section 848, an insurance company is required to capitalize an amount of otherwise deductible expenses equal to a percentage of the net premiums for the taxable year for certain categories of insurance contracts. The capitalized amounts, commonly referred to as deferred acquisition costs, or "DAC," are amortized on a straight-line basis over 120 months.

Section 197(f)(5) is designed to ensure that the DAC amounts attributable to an assumption reinsurance transaction are amortized over the period specified by section 848 rather than the longer period under section 197. To achieve this result, the adjusted basis of the amortizable section 197 intangible resulting from an assumption reinsurance transaction is recognized only to the extent that the amount paid or incurred by the acquirer for the relevant contracts exceeds the DAC taken into account under section 848 as a result of the transaction.

The proposed regulations provide rules to determine the amounts paid or incurred for amortizable section 197 intangibles

with respect to contracts acquired as a result of assumption reinsurance transactions occurring as part of transactions governed by section 1060 or section 338. The proposed regulations also provide rules for purposes of determining the DAC amounts for the transactions. See proposed §1.197-2(g)(5).

Under the proposed regulations, the amount paid or incurred by the acquirer under the assumption reinsurance transaction in a transaction governed by section 338 or 1060 is the amount of adjusted grossed up basis (AGUB) or consideration allocable to the insurance contracts under the residual method. The amount required to be capitalized under section 848 in connection with the assumption reinsurance transaction is determined by multiplying the acquirer's specified policy acquisition expenses for the taxable year by a fraction, the numerator of which is the total tentative positive capitalization amount for the relevant group of acquired insurance contracts and the denominator of which is the total tentative required capitalization amount for the taxable year for all specified insurance contracts. The tentative positive capitalization amount for the relevant group of acquired insurance contracts is the net positive consideration received for the contracts in the assumption reinsurance transaction multiplied by the percentage factor applicable to the contracts under section 848(c).

An insurance company's DAC amount may not exceed the company's general deductions for the taxable year. See section 848(c). The amortization of intangibles under section 197 is a general deduction relevant in computing DAC. However, the amount of amortization under section 197 cannot be calculated until section 197(f)(5) is applied. To avoid complex calculations, for purposes of calculating the basis of amortization, the proposed regulations presume that one-half of the consideration allocated to the insurance contracts is amortizable under section 197. See proposed §1.197-2(g)(5)(i)(D)(2). Comments were requested regarding alternative approaches to calculating the basis for DAC amounts and section 197 amortization.

A number of comments were received relating to the proposed regulations under section 197(f)(5). Commentators requested that the final regulations clar-

ify that section 197(f)(5) applies only to assumption reinsurance transactions, and not to indemnity reinsurance transactions. Commentators asked that the final regulations clarify that the full amount of consideration allocable to the reinsured contracts is currently deductible under section 848(g) when the provisions of section 848 apply to an indemnity reinsurance transaction that occurs as part of a section 1060 acquisition of an insurance business. Commentators also expressed concern that the proposed regulations could cause an acquirer's DAC under section 848 to be subject to the general deductions cap in section 848(c) despite the existence of a substantial ceding commission. Commentators requested that the final regulations clarify that the election under §1.848-2(g)(8) is available to allow old target and new target in a deemed asset sale governed by section 338(h)(10) to determine the amount of DAC attributable to the transaction without regard to the general deductions limitation.

The temporary and proposed regulations generally follow the proposed rules under section 197(f)(5), subject to several modifications. In particular, the temporary and proposed rules build on the method under §1.848-2(g) of the existing regulations for determining the amounts capitalized under section 848 for a reinsurance agreement. Under the 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.

The temporary and proposed regulations also modify the special rule in the proposed regulations with respect to the interplay between section 197(f)(5) and section 848 as regards the determination of the acquirer's general deductions under section 848(c)(2). 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.

If the acquirer has a capitalization shortfall (*i.e.*, the amount of general deductions allocable to the assumption reinsurance transaction is less than the required capitalization amount for the transaction), the temporary and proposed regulations permit the acquirer and the ceding company to elect under §1.848-2(g)(8) to determine the amount capitalized under section 848 without regard to the general deductions limitation. The additional amounts capitalized by the acquirer as a result of the election are treated as first reducing the adjusted basis of the amortizable section 197 intangible with regard to the insurance contracts acquired in the assumption reinsurance transaction, before reducing the acquirer's otherwise deductible expenses. The temporary and proposed rules generally allow the acquirer to amortize a larger amount over the period specified by section 848 as compared to the proposed regulations.

The temporary and proposed regulations generally apply, on a cut-off basis, to acquisitions and dispositions on or after April 10, 2006. Thus, there is no adjustment under section 481(a). Taxpayers must make the change on their income tax return and should not file a Form 3115, *Application for Change in Accounting Method*. Taxpayers are permitted, however, to apply the regulations to acquisitions before that date on a transaction-by-transaction basis, with an adjustment under section 481(a). The temporary and proposed regulations provide a procedure for taxpayers to obtain automatic consent of the Commissioner to do so.

B. Recovery of Basis on Dispositions of Acquired Insurance Contracts

Proposed §1.197-2(g)(5)(ii)(A)(2) provides 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. Sufficient economic rights are treated as transferred when the ceding company transfers the right to future income on the contracts. The proposed regulations also provide

rules governing the amount of loss recognized on the disposition of a section 197(f)(5) intangible. The proposed regulations requested comments whether additional guidance should address other situations or issues.

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 and Treasury Department continue to believe that the rules contained in these regulations should refer to general tax principles, and will as needed, address these issues in future published guidance.

C. Reserve Increases by New Target After the Deemed Asset Sale

When a section 338 election is made for an insurance company, §1.338-11(d) of the proposed regulations provides that new target must capitalize its increases in reserves for any acquired contracts in the deemed asset sale. Similar principles apply for an applicable asset acquisition of an insurance business under section 1060. The 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. However, the proposed regulations do not require capitalization to the extent the increases in reserves reflect the time value of money, to the extent the increases in reserves occur while new target is under state receivership, or to the extent the deduction for the increases in reserves is spread over the 10 succeeding taxable years under section 807(f).

Many commentators objected to the rule requiring capitalization for increases in reserves after the transaction date. They questioned the justification for the rule, stating that the rule was inconsistent with, and overrode, principles established under subchapter L for determining losses incurred. Commentators argued that, under subchapter L principles, reserve liabilities are not treated like contingent liabilities and that it was inappropriate to treat the reserves as contingent liabilities even for

the limited purposes of the regulation. Commentators also requested that the application of the rule be restricted to cases of abuse because the ceding company's reserves assumed in the transaction are fair and reasonable estimates under Subchapter L as of the transaction date.

The commentators' objections largely ignore the fact that the proposed regulations blend elements of the asset purchase model common to most taxpayers that dispose of or acquire assets for consideration that includes the discharge of liabilities and the services model that generally applies to insurance companies. Treating increases in reserves for acquired contracts similarly to contingent liabilities under the asset purchase model is just one aspect of that amalgam.

Under the asset purchase model, assumed contingent liabilities are an element of the consideration for which a buyer acquires assets. Thus, a buyer includes the contingent liability in its cost for the acquired assets. However, a buyer may not include the contingent liability in its cost until the liability is incurred for Federal income tax purposes. The buyer must capitalize the liability in the cost of the acquired assets even if the buyer could have currently deducted the liability had it arisen in the buyer's historic business. Under the asset purchase model, the buyer does not realize any income for the assumption of the contingent liability; the buyer merely has bought assets. See *Commissioner v. Oxford Paper*, 194 F.2d 190 (2d Cir. 1951).

Under the services model, the seller (or ceding company) is treated as paying a premium to the buyer (or reinsurer) to assume the risk on its insurance contracts. The reinsurer includes in income the receipt of the premium and has a deduction for its increase in reserves for the additional risks assumed in the transaction. The amount of the premium income is generally equal to the consideration paid by the ceding company, that is, the fair market value of the assets that the ceding company transfers to the reinsurer in the transaction (though it may not be less than the amount of the reinsurer's increase in tax reserves, see §1.817-4(d)(2)(iii)). Thus, when the fair market value of the assets that the ceding company transfers exceeds the reinsurer's increase in tax reserves for the additional risks assumed in the transaction, the rein-

surer has net income. See §1.817-4(d)(3) *Example 4*. Under the services model, no liabilities are treated as contingent liabilities. The reserve rules effectively treat increases to reserves for new risks as fixed liabilities and increases to reserves for existing risks as period expenses (similar to interest).

The proposed regulations blend the asset purchase model and the services model by—

(1) Using the residual method of sections 338 and 1060 to determine the value of goodwill and going concern value (which assumes that the value of all assets other than goodwill and going concern value is readily determinable) rather than the residual method of §1.817-4(d) to determine the value of insurance in force (which assumes that the value of all assets other than insurance in force is readily determinable);

(2) Treating the amount of old target's tax reserves as a fixed liability as of the close of the acquisition date that is taken into account in determining the seller's aggregate deemed sales price (ADSP) under §1.338-4 and the buyer's AGUB under §1.338-5;

(3) Treating certain of new target's increases in reserves for any insurance contracts acquired in the deemed asset sale as a contingent liability as of the close of the acquisition date that becomes fixed when new target increases its reserves;

(4) Assuming that the amount of reinsurance premium is equal to the amount of old target's tax reserves, even though the ceding company would have to pay the reinsuring company an amount greater than the tax reserves in an arm's length reinsurance transaction. This rule ensures that the acquirer of an insurance business will not have immediate net taxable income merely as a result of the acquisition; and

(5) Not requiring capitalization for new target's increases in reserves due to the time value of money for any insurance contracts acquired in the deemed asset sale.

The proposed regulations generally treat an insurance company's assumption of contingent liabilities related to insurance contracts more favorably than a noninsurance company's assumption of a similar contingent liability. The proposed regulations also treat an insurance

company's assumption of contingent liabilities related to insurance contracts more favorably than subchapter L does. As discussed previously, under subchapter L, a reinsurer may have net income when entering into an assumption reinsurance transaction. The amount of the income is the amount of the bargain, that is, the excess of fair market value of the assets the seller transfers over the amount of the consideration the buyer pays at closing (in an assumption reinsurance transaction, the latter measured by the reinsurer's increase in tax reserves for the risks assumed in the transaction). The proposed regulations, unlike subchapter L, require income to be recognized if there is an increase in certain reserves for the acquired insurance contracts.

The IRS and Treasury Department believe that a rule requiring capitalization of increases to reserves is a necessary corollary to the rule in the proposed regulations linking the amount of reinsurance deemed paid to the amount of old target's tax reserves at the time of the assumption reinsurance transaction (with the concomitant result that new target has no income). The logical implication of the commentators' arguments would be that the buyer should have premium income in a bargain purchase. In addition, without requiring capitalization of at least some increases to reserves, there is an incentive for sellers to defer increases in reserves. This incentive results from the fact that while the seller is generally indifferent to an increase in reserves (the immediate deduction to the seller would be offset by a corresponding increase in amount realized of ADSP in the sale), a buyer would be entitled to an immediate deduction rather than increased basis from an increase in the seller's reserves.

In response to comments, the IRS and Treasury Department have decided to issue temporary regulations with these final regulations that continue to require capitalization (and concomitant treatment as premium) of certain reserve increases, but further limit the capitalization rule of the proposed regulations in a manner consistent with the application of subchapter L principles. See §1.338-11T(d). After the deemed asset sale, the temporary regulations apply subchapter L principles to new target. Under the temporary regulations, capitalization is required only for increases

in reserves that clearly reflect a so called “bargain purchase” (that is, when the application of the residual method clearly indicates the initial understatement of the reserve). The amount of the bargain purchase is the amount of income the reinsurer would have otherwise recognized under §1.817-4(d) if the final regulations (and proposed regulations) had not adopted the convention that the reinsurance premium paid by the seller to the buyer is deemed to equal the seller’s closing tax reserves, and were it not necessary to employ a residual method to account for the presence of non-insurance intangible assets.

Under the temporary regulations, new target is required to capitalize any increases in reserves for acquired contracts if the AGUB allocated to assets in Class I through Class V is less than the fair market value of the assets in those classes. Any deductions would continue to be capitalized until the basis of the assets in Class I through Class V is equal to their fair market value. This mechanism avoids the problem of valuing Class VI and Class VII intangibles. The approach of the temporary regulations essentially treats the ceding company as transferring no Class VI or Class VII assets to the reinsurer for the reinsurer’s assumption of the liabilities on the acquired contracts. Because the temporary regulations limit the total amount of capitalization for increases in reserves for acquired contracts, the IRS and Treasury Department believe 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.

D. Allocation of ADSP and AGUB to Specific Insurance Contracts

Proposed §1.338-11(b)(2) provides a rule 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 pre-

mium for the contracts were equal to old target’s tax reserves for the contracts.

Commentators questioned the reliance of the proposed regulations upon tax reserves as a basis for valuing the contracts and asked that the value of the contracts be based on GAAP or statutory reserves, or an amount upon which the parties agree. The IRS and Treasury Department believe that using tax reserves as a basis for valuing the contracts is consistent with other areas in which tax reserves, not GAAP or statutory reserves, are used to compute taxable income. See, e.g., section 807 (prescribing rules for taking life insurance reserves and certain other reserves into account for purposes of computing life insurance company taxable income); section 846 (prescribing a methodology for discounting unpaid loss reserves for purposes of computing insurance company taxable income); and Rev. Proc. 90-36, 1990-2 C.B. 357 (computing up-front ceding commission paid by a reinsurer as the increase in the reinsurer’s tax reserve liabilities resulting from the reinsurance transaction, minus the value of the net assets received, for purposes of capitalizing ceding commissions to comply with the Supreme Court decision in *Colonial American Life Insurance Company v. Commissioner*, 491 U.S. 244 (1989), (1989-2 C.B. 110, Ct. D. 2045). Moreover, in the context of a transaction governed by section 338 or 1060, the use of old target’s tax reserves as a means of valuing the contracts is consistent with both (i) the treatment of old target’s closing tax reserves as a liability in the computation of the seller’s ADSP and the buyer’s AGUB, and (ii) the general rule of §1.817-4(d)(2)(iii), which treats the assuming company in an assumption reinsurance transaction as receiving premium income equal to at least the increase in its reserves.

E. Effect of Section 338 Election on Section 846(e) Election by Old Target

The proposed regulations do 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. See §1.338-1(b).

Commentators believed that this result was inconsistent with the purpose of allowing a company to make a section 846(e) election. Commentators noted that a section 846(e) election is made for all eligible lines of business, determined by reference to the accident years for the line of business shown on the insurance company’s annual statement. Additionally, commentators noted that the availability of the election should not depend upon the tax identity of new target after the section 338 election because the historical loss payment pattern is not a tax account, the pattern is determined by reference to nontax factors, and new target continues to operate in the same manner and legal form as old target.

In response to these comments, the temporary regulations contain a new rule that treats new target and old target as the same corporation for purposes of a section 846(e) election to use an insurance company’s historical loss payment pattern. See §1.338-1T(b)(2)(vii). Therefore, if old target has a section 846(e) election in effect, new target will continue to use the historical loss payment pattern of old target to discount unpaid losses, unless new target chooses to revoke the election. If new target revokes old target’s section 846(e) election, new target will use the industry-wide factors determined by the Secretary to discount unpaid losses incurred in accident years beginning on or after the acquisition date. See §1.338-11T(e)(2).

F. Treatment of Shareholders Surplus Accounts, Policyholders Surplus Accounts (PSA), and Other Accounts in Transactions to Which Section 381 Applies

Section 1.381(c)(22)-1(b)(7)(i) of the proposed regulations provides that if one corporation distributes or transfers a substantial portion (50 percent or more) of an insurance business to another corporation in a transaction to which section 381 applies, then the acquiring corporation succeeds to the distributor or transferor corporation’s shareholders surplus account, policyholders surplus account, and other accounts. However, under §1.381(c)(22)-1(b)(7)(ii) of the proposed

regulations, if an acquiring corporation in the section 381 transaction acquires less than 50 percent of the distributor or transferor corporation's insurance business, then the acquiring corporation succeeds only to a ratable portion (determined by reference to reserves) of the distributor or transferor corporation's shareholders surplus account, policyholders surplus account, and other accounts.

Commentators questioned whether the IRS and Treasury Department have the authority to relate the carryover of PSA to the percentage of business that was transferred to the acquiring corporation in a section 381 transaction. The IRS and Treasury Department believe that the rule in the proposed regulations is appropriate and that there is sufficient authority for the proposed rule. The legislative history to the 1984 Tax Reform Act indicates that the term *indirect distribution* is to be interpreted broadly to include any use of PSA funds for the indirect benefit of shareholders. H.R. Rep. No. 432, pt. 2, 98th Cong., 2d Sess. at 1410–11; Staff of the Joint Committee on Taxation, 98th Cong., 2d Sess., *General Explanation of the Revenue Provisions of the Tax Reform Act of 1984*, at 594 (1984), as well as *Bankers Life and Casualty Co. v. United States*, 79 AFTR2d (RIA) 1726 (N.D. Ill. 1996), aff'd on other grounds, 142 F.3d 973 (7th Cir. 1998), cert denied, 525 U.S. 961 (1998) (section 338(g) transaction results in an indirect distribution of old target's PSA). Accordingly, the final regulations adopt the rule as proposed in §§1.338–11(f) and 1.381(c)(22)–1(b)(7).

G. Treatment of DAC in Transactions to Which Section 381 Applies

Section 1.381(c)(22)–1(b)(13) of the proposed regulations provides that any remaining balances of DAC or excess negative DAC carry over to a successor insurance company in a section 381 transaction. One commentator questioned whether a nonlife insurance company may succeed to DAC attributes under §1.381(c)(22)–1. Another commentator believed positive DAC should not be carried over to a successor corporation in a section 381 transaction.

The IRS and Treasury Department believe that in a section 381 transaction, positive DAC, like negative DAC, is an at-

tribute that is carried over to the acquiring corporation. Thus, the 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. See §1.381(c)(22)–1(b)(13). However, the IRS and Treasury Department believe that a proportionality rule similar to the one the final regulations adopt at §1.381(c)(22)–1(b)(7) for policyholder surplus accounts is appropriate because DAC is a tax accounting convention that relates to a line of business. Thus, the final regulations provide that when the acquiring corporation acquires 50 percent or more of the distributor or transferor corporation's insurance business (measured by its reserves for all of its contracts immediately before the earlier of the distribution or transfer or the adoption of the plan of liquidation or reorganization), the acquiring corporation will succeed to the distributor or transferor corporation's entire positive or negative DAC amount. To the extent an acquiring corporation in the section 381 transaction acquires less than 50 percent of the distributor or transferor corporation's insurance business, then only that percentage of positive or negative DAC remains. In addition, because some attributes under section 381(c)(22) and §1.381(c)(22)–1 are equally relevant for life and nonlife insurance companies, the final regulations clarify that, except as otherwise provided, the rules in §1.381(c)(22)–1 apply to any insurance company, whether a life or a nonlife company.

H. Effective Date of Regulations

The final and temporary regulations are effective for transactions on or after April 10, 2006. Commentators asked for an election to apply the final regulations to transactions completed before April 10, 2006. The IRS and Treasury Department believe that the elective retroactivity of the final regulations is warranted and administrable. Thus, the final regulations permit new target and old target an election to apply the final regulations, in whole, to qualified stock purchases occurring before April 10, 2006, if all taxable years for which the consequences of the section 338 election affect the computation of tax are open. In the case of a section 338 election for which

a section 338(h)(10) election is made (or a section 338 election for a foreign target), new target's ability to elect to retroactively apply the final regulations does not depend upon old target making the election. Similarly, old target's ability to elect to retroactively apply the final regulations does not depend upon new target making the election. However, in the case of a section 338 election for a domestic target for which no section 338(h)(10) election is made, the purchasing corporation generally controls both the filing of new target's returns and old target's final return. Accordingly, when no section 338(h)(10) election is made and the target is a domestic corporation, new target and old target must both elect to retroactively apply the final regulations. If one of new target or old target cannot make the election, the other is not permitted to make the election. See §1.338(i)–1(c).

Special Analyses

It has been determined that the final regulations issued with respect to section 197 and section 338 are not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It is hereby certified that the collection of information requirement in these regulations will not have a significant economic impact on a substantial number of small entities. This certification is based on the fact that these regulations do not have a substantial economic impact because they merely provide guidance about the operation of the tax law in the context of acquisitions of insurance companies and businesses. Moreover, they are expected to apply predominantly to transactions involving larger businesses. In addition, the collection of information requirement merely requires a taxpayer to prepare a written representation that contains minimal information relating to the making of an election. Therefore, a Regulatory Flexibility Analysis under the Regulatory Flexibility Act (5 U.S.C. chapter 6) is not required. Under section 7805(f) of the Code, the notice of proposed rule-making preceding this regulation was submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business. The Chief Counsel for Advocacy did not submit any comments on the regulations.

It has been determined that the temporary regulations issued with respect to sections 197 and 338 are not a significant regulatory action as defined in Executive Order 12866. Therefore a regulatory assessment is not required. These regulations provide guidance relating to the taxable acquisition and disposition of insurance companies. Additionally, these regulations provide rules by which a party to the transaction may elect to apply these rules to transactions which occur prior to April 10, 2006. Based on these considerations, it is determined that these temporary regulations will provide taxpayers with the necessary guidance and authority to ensure equitable administration of the tax laws. Because of the need for immediate guidance, notice and public procedure are impracticable and contrary to the public interest pursuant to 5 U.S.C. 533(b) and the delayed effective date is not required pursuant to 5 U.S.C. 553(d). For applicability of the Regulatory Flexibility Act to these temporary regulations, please refer to the cross-reference notice of proposed rulemaking published elsewhere in this Bulletin. Pursuant to section 7805(f) of the Code, these temporary regulations will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on their impact on small business.

It has been determined that the final regulations issued with respect to sections 381, 846 and 1060 are not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It has also been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations, and, because the regulations do not impose a collection of information on small entities, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. Therefore, a Regulatory Flexibility Analysis under the Regulatory Flexibility Act (5 U.S.C. chapter 6) is not required. Under section 7805(f) of the Code, the notice of proposed rulemaking preceding this regulation was submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business. The Chief Counsel for Advocacy did not submit any comments on the regulations.

Drafting Information

The principal author of the final regulations is Mark J. Weiss, Office of Chief Counsel (Corporate), IRS. However, other personnel from the IRS and Treasury Department participated in their development.

* * * * *

Adoption of Amendments to the Regulations

Accordingly, 26 CFR parts 1 and 602 are amended as follows:

PART 1—INCOME TAXES

Paragraph 1. The authority citation for part 1 is amended by adding entries in numerical order to read in part as follows:

Authority: 26 U.S.C. 7805 * * *

Section 1.197-2 also issued under 26 U.S.C. 197.

Section 1.197-2T also issued under 26 U.S.C. 197. * * *

Section 1.338-11 also issued under 26 U.S.C. 338.

Section 1.338-11T also issued under 26 U.S.C. 338. * * *

Section 1.846-2(d) is also issued under 26 U.S.C. 846. * * *

Par. 2. In §1.197-0, the entries in the table of contents for §1.197-2, paragraph (g)(5) are revised and §1.197-2T is added to read as follows:

§1.197-0 Table of contents.

This section lists the headings that appear in §§1.197-2 and 1.197-2T.

§1.197-2 Amortization of goodwill and certain other intangibles.

* * * * *

(g) * * *

(5) Treatment of certain insurance contracts acquired in an assumption reinsurance transaction.

(i) In general.

(ii) Determination of adjusted basis of amortizable section 197 intangible resulting from an assumption reinsurance transaction.

(iii) Application of loss disallowance rule upon a disposition of an insurance contract acquired in an assumption reinsurance transaction.

- (A) Disposition.
- (I) In general.
- (2) Treatment of indemnity reinsurance transactions.
- (B) Loss.
- (C) Examples.
- (iv) Effective dates.
- (A) In general.
- (B) Application to pre-effective date acquisitions and dispositions.
- (C) Change in method of accounting.
- (I) In general.
- (2) Acquisitions and dispositions on or after effective date.
- (3) Acquisitions and dispositions before the effective date.

* * * * *

§1.197-2T Amortization of goodwill and certain other intangibles (temporary).

- (a) through (g)(5)(i) [Reserved].
- (ii) Determination of adjusted basis of amortizable section 197 intangible resulting from an assumption reinsurance transaction.
- (A) In general.
- (B) Amount paid or incurred by acquirer (reinsurer) under the assumption reinsurance transaction.
- (C) Amount required to be capitalized under section 848 in connection with the transaction.

(1) In general.

(2) Required capitalization amount.

(3) General deductions allocable to the assumption reinsurance transaction.

(4) Treatment of a capitalization shortfall allocable to the reinsurance agreement.

(i) In general.

(ii) Treatment of additional capitalized amounts as the result of an election under §1.848-2(g)(8).

(5) Cross references and special rules.

(D) Examples.

(E) Effective date.

(g)(5)(iii) through (I) [Reserved].

Par. 3. Section 1.197-2 is amended by revising paragraph (g)(5) to read as follows:

§1.197-2 Amortization of goodwill and certain other intangibles.

* * * * *

(g) * * *

(5) Treatment of certain insurance contracts acquired in an assumption reinsurance transaction.

ance transaction—(i) *In general.* Section 197 generally applies to insurance and annuity contracts acquired from another person through an assumption reinsurance transaction. See §1.809–5(a)(7)(ii) for the definition of assumption reinsurance. The transfer of insurance or annuity contracts and the assumption of related liabilities deemed to occur by reason of a section 338 election for a target insurance company is treated as an assumption reinsurance transaction. The transfer of a reinsurance contract by a reinsurer (transferor) to another reinsurer (acquirer) is treated as an assumption reinsurance transaction if the transferor's obligations are extinguished as a result of the transaction.

(ii) *Determination of adjusted basis of amortizable section 197 intangible resulting from an assumption reinsurance transaction.* For further guidance, see §1.197–2T(g)(5)(ii).

(iii) *Application of loss disallowance rule upon a disposition of an insurance contract acquired in an assumption reinsurance transaction.* The following rules apply for purposes of applying the loss disallowance rules of section 197(f)(1)(A) to the disposition of a section 197(f)(5) intangible. For this purpose, a section 197(f)(5) intangible is an amortizable section 197 intangible the basis of which is determined under section 197(f)(5).

(A) *Disposition*—(1) *In general.* A disposition of a section 197 intangible is any event as a result of which, absent section 197, recovery of basis is otherwise allowed for Federal income tax purposes.

(2) *Treatment of indemnity reinsurance transactions.* The transfer through indemnity reinsurance of the right to the future income from the insurance contracts to which a section 197(f)(5) intangible relates does not preclude the recovery of basis by the ceding company, provided that sufficient economic rights relating to the reinsured contracts are transferred to the reinsurer. However, the ceding company is not permitted to recover basis in an indemnity reinsurance transaction if it has a right to experience refunds reflecting a significant portion of the future profits on the reinsured contracts, or if it retains an option to reacquire a significant portion of the future profits on the reinsured contracts through the exercise of a recapture provision. In addition, the ceding company is not permitted to recover basis in an in-

demnity reinsurance transaction if the reinsurer assumes only a limited portion of the ceding company's risk relating to the reinsured contracts (excess loss reinsurance).

(B) *Loss.* The loss, if any, recognized by a taxpayer on the disposition of a section 197(f)(5) intangible equals the amount by which the taxpayer's adjusted basis in the section 197(f)(5) intangible immediately before the disposition exceeds the amount, if any, that the taxpayer receives from another person for the future income right from the insurance contracts to which the section 197(f)(5) intangible relates. In determining the amount of the taxpayer's loss on the disposition of a section 197(f)(5) intangible through a reinsurance transaction, any effect of the transaction on the amounts capitalized by the taxpayer as specified policy acquisition expenses under section 848 is disregarded.

(C) *Examples.* The following examples illustrate the principles of this paragraph (g)(5)(iii):

Example 1. (i) *Facts.* In a prior taxable year, as a result of a section 338 election with respect to T, new T was treated as purchasing all of old T's insurance contracts that were in force on the acquisition date in an assumption reinsurance transaction. Under §§1.338–6 and 1.338–11(b)(2), the amount of AGUB allocable to the future income right from the purchased insurance contracts was \$15, net of the amounts required to be capitalized under section 848 as a result of the assumption reinsurance transaction. At the beginning of the current taxable year, as a result of amortization deductions allowed by section 197(a), new T's adjusted basis in the section 197(f)(5) intangible resulting from the assumption reinsurance transaction is \$12. During the current taxable year, new T enters into an indemnity reinsurance agreement with R, another insurance company, in which R assumes 100 percent of the risk relating to the insurance contracts to which the section 197(f)(5) intangible relates. In the indemnity reinsurance transaction, R agrees to pay new T a ceding commission of \$10 in exchange for the future profits on the underlying reinsured policies. Under the indemnity reinsurance agreement, new T continues to administer the reinsured policies, but transfers investment assets equal to the required reserves for the reinsured policies together with all future premiums to R. The indemnity reinsurance agreement does not contain an experience refund provision or a provision allowing new T to terminate the reinsurance agreement at its sole option. New T retains the insurance licenses and other amortizable section 197 intangibles acquired in the deemed asset sale and continues to underwrite and issue new insurance contracts.

(ii) *Analysis.* The indemnity reinsurance agreement constitutes a disposition of the section 197(f)(5) intangible because it involves the transfer of sufficient economic rights attributable to the insurance contracts to which the section 197(f)(5) intangible re-

lates such that recovery of basis is allowed. For purposes of applying the loss disallowance rules of section 197(f)(1) and paragraph (g) of this section, new T's loss is \$2 (new T's adjusted basis in the section 197(f)(5) intangible immediately before the disposition (\$12) less the ceding commission (\$10)). Therefore, new T applies \$10 of the adjusted basis in the section 197(f)(5) intangible against the amount received from R for the future income right on the reinsured policies and increases its basis in the amortizable section 197 intangibles that it acquired and retained from the deemed asset sale by \$2, the amount of the disallowed loss. The amount of new T's disallowed loss under section 197(f)(1)(A) is determined without regard to the effect of the indemnity reinsurance transaction on the amounts capitalized by new T as specified policy acquisition expenses under section 848.

Example 2. (i) *Facts.* Assume the same facts as in *Example 1*, except that under the indemnity reinsurance agreement R agrees to pay new T a ceding commission of \$5 with respect to the underlying reinsured contracts. In addition, under the indemnity reinsurance agreement, new T is entitled to an experience refund equal to any future profits on the reinsured contracts in excess of the ceding commission plus an annual risk charge. New T also has a right to recapture the business at any time after R has recovered an amount equal to the ceding commission.

(ii) *Analysis.* The indemnity reinsurance agreement between new T and R does not represent a disposition because it does not involve the transfer of sufficient economic rights with respect to the future income on the reinsured contracts. Therefore, new T may not recover its basis in the section 197(f)(5) intangible to which the contracts relate and must continue to amortize ratably the adjusted basis of the section 197(f)(5) intangible over the remainder of the 15-year recovery period and cannot apply any portion of this adjusted basis to offset the ceding commission received from R in the indemnity reinsurance transaction.

(iv) *Effective dates*—(A) *In general*—This paragraph (g)(5) applies to acquisitions and dispositions on or after April 10, 2006. For rules applicable to acquisitions and dispositions before that date, see §1.197–2 in effect before that date (see 26 CFR part 1, revised April 1, 2001).

(B) *Application to pre-effective date acquisitions and dispositions.* A taxpayer may choose, on a transaction-by-transaction basis, to apply the provisions of this paragraph (g)(5) to property acquired and disposed of before April 10, 2006.

(C) *Change in method of accounting*—(1) *In general*—A change in a taxpayer's treatment of all property acquired and disposed under paragraph (g)(5) is a change in method of accounting to which the provisions of sections 446 and 481 and the regulations thereunder apply.

(2) *Acquisitions and dispositions on or after effective date.* A Taxpayer is granted the consent of the Commissioner under section 446(e) to change its method of accounting to comply with this paragraph (g)(5) for acquisitions and dispositions on or after April 10, 2006. The change must be made on a cut-off basis with no section 481(a) adjustment. Notwithstanding §1.446-1(e)(3), a taxpayer should not file a Form 3115, “*Application for Change in Accounting Method*,” to obtain the consent of the Commissioner to change its method of accounting under this paragraph (g)(5)(iv)(C)(2). Instead, a taxpayer must make the change by using the new method on its federal income tax returns.

(3) *Acquisitions and dispositions before the effective date.* For the first taxable year ending after April 10, 2006, a taxpayer is granted consent of the Commissioner to change its method of accounting for all property acquired in transactions described in paragraph (g)(5)(iv)(B) to comply with this paragraph (g)(5) unless the proper treatment of any such property is an issue under consideration in an examination, before an Appeals office, or before a Federal Court. (For the definition of when an issue is under consideration, see, Rev. Proc. 97-27, 1997-1 C.B. 680; and, §601.601(d)(2) of this chapter). A taxpayer changing its method of accounting in accordance with this paragraph (g)(5)(iv)(C)(3) must follow the applicable administrative procedures for obtaining the Commissioner’s automatic consent to a change in method of accounting (for further guidance, see, for example, Rev. Proc. 2002-9, 2002-1 C.B. 327, as modified and clarified by Announcement 2002-17, 2002-1 C.B. 561, modified and amplified by Rev. Proc. 2002-19, 2002-1 C.B. 696, and amplified, clarified and modified by Rev. Proc. 2002-54, 2002-2 C.B. 432; and, §601.601(d)(2) of this chapter), except, for purposes of this paragraph (g)(5)(iv)(C)(3), any limitations in such administrative procedures for obtaining the automatic consent of the Commissioner shall not apply. However, if the taxpayer is under examination, before an appeals office, or before a Federal court, the taxpayer must provide a copy of the application to the examining agent(s), appeals officer, or counsel for the government, as appropriate, at the same time that it files the copy of the application with

the National Office. The application must contain the name(s) and telephone number(s) of the examining agent(s), appeals officer, or counsel for the government, as appropriate. For purposes of Form 3115, “*Application for Change in Accounting Method*,” the designated number for the automatic accounting method change authorized by this paragraph (g)(5)(iv)(C)(3) is “98”. A change in method of accounting in accordance with this paragraph (g)(5)(iv)(C)(3) requires an adjustment under section 481(a).

* * * * *

Par. 4. Section 1.197-2T is added to read as follows:

§1.197-2T Amortization of goodwill and certain other intangibles (temporary).

(a) through (g)(5)(i) [Reserved]. For further guidance, see §1.197-2(a) through (g)(5)(i).

(g)(5)(ii) *Determination of adjusted basis of amortizable section 197 intangible resulting from an assumption reinsurance transaction—(A) In general.* Section 197(f)(5) determines the basis of an amortizable section 197 intangible for insurance or annuity contracts acquired in an assumption reinsurance transaction. The basis of such intangible is the excess, if any, of—

(1) The amount paid or incurred by the acquirer (reinsurer) under the assumption reinsurance transaction; over

(2) The amount, if any, required to be capitalized under section 848 in connection with such transaction.

(B) *Amount paid or incurred by acquirer (reinsurer) under the assumption reinsurance transaction.* The amount paid or incurred by the acquirer (reinsurer) under the assumption reinsurance transaction is —

(1) In a deemed asset sale resulting from an election under section 338, the amount of the AGUB allocable thereto (see §§1.338-6 and 1.338-11(b)(2));

(2) In an applicable asset acquisition within the meaning of section 1060, the amount of the consideration allocable thereto (see §§1.338-6, 1.338-11(b)(2), and 1.1060-1(c)(5)); and

(3) In any other transaction, the excess of the increase in the reinsurer’s tax reserves resulting from the transaction (computed in accordance with sections

807, 832(b)(4)(B), and 846) over the value of the net assets received from the ceding company in the transaction.

(C) *Amount required to be capitalized under section 848 in connection with the transaction—(1) In general.* The amount required to be capitalized under section 848 for specified insurance contracts (as defined in section 848(e)) acquired in an assumption reinsurance transaction is the lesser of—

(i) The reinsurer’s required capitalization amount for the assumption reinsurance transaction; or

(ii) The reinsurer’s general deductions (as defined in section 848(c)(2)) allocable to the transaction.

(2) *Required capitalization amount.* The reinsurer determines the required capitalization amount for an assumption reinsurance transaction by multiplying the net positive or net negative consideration for the transaction by the applicable percentage set forth in section 848(c)(1) for the category of specified insurance contracts acquired in the transaction. See §1.848-2(g)(5). If more than one category of specified insurance contracts is acquired in an assumption reinsurance transaction, the required capitalization amount for each category is determined as if the transfer of the contracts in that category were made under a separate assumption reinsurance transaction. See §1.848-2(f)(7).

(3) *General deductions allocable to the assumption reinsurance transaction.* The reinsurer determines the general deductions allocable to the assumption reinsurance transaction in accordance with the procedure set forth in §1.848-2(g)(6). Accordingly, the reinsurer must allocate its general deductions to the amount required under section 848(c)(1) on specified insurance contracts that the reinsurer has issued directly before determining the general deductions allocable to the assumption reinsurance transaction. For purposes of allocating its general deductions under §1.848-2(g)(6), the reinsurer includes premiums received on the acquired specified insurance contracts after the assumption reinsurance transaction in determining the amount required under section 848(c)(1) on specified insurance contracts that the reinsurer has issued directly. If the reinsurer has entered into multiple reinsurance agreements during the taxable year, the reinsurer determines the general de-

ductions allocable to each reinsurance agreement (including the assumption reinsurance transaction) by allocating the general deductions allocable to reinsurance agreements under §1.848-2(g)(6) to each reinsurance agreement with a positive required capitalization amount.

(4) *Treatment of a capitalization shortfall allocable to the reinsurance agreement*—(i) *In general.* The reinsurer determines any capitalization shortfall allocable to the assumption reinsurance transaction in the manner provided in §§1.848-2(g)(4) and 1.848-2(g)(7). If the reinsurer has a capitalization shortfall allocable to the assumption reinsurance transaction, the ceding company must reduce the net negative consideration (as determined under §1.848-2(f)(2)) for the transaction by the amount described in §1.848-2(g)(3) unless the parties make the election provided in §1.848-2(g)(8) to determine the amounts capitalized under section 848 in connection with the transaction without regard to the general deductions limitation of section 848(c)(2).

(ii) *Treatment of additional capitalized amounts as the result of an election under §1.848-2(g)(8).* The additional amounts capitalized by the reinsurer as the result of the election under §1.848-2(g)(8) reduce the adjusted basis of any amortizable section 197 intangible with respect to specified insurance contracts acquired in the assumption reinsurance transaction. If the additional capitalized amounts exceed the adjusted basis of the amortizable section 197 intangible, the reinsurer must reduce its deductions under section 805 or section 832 by the amount of such excess. The additional capitalized amounts are treated as specified policy acquisition expenses attributable to the premiums and other consideration on the assumption reinsurance transaction and are deducted ratably over a 120-month period as provided under section 848(a)(2).

(5) *Cross references and special rules.* In general, for rules applicable to the determination of specified policy acquisition expenses, net premiums, and net consideration, see section 848(c) and (d), and §1.848-2(a) and (f). However, the following special rules apply for purposes of this paragraph (g)(5)(ii)(C)—

(i) The amount required to be capitalized under section 848 in connection with

the assumption reinsurance transaction cannot be less than zero;

(ii) For purposes of determining the company's general deductions under section 848(c)(2) for the taxable year of the assumption reinsurance transaction, the reinsurer takes into account a tentative amortization deduction under section 197(a) as if the entire amount paid or incurred by the reinsurer for the specified insurance contracts were allocated to an amortizable section 197 intangible with respect to insurance contracts acquired in an assumption reinsurance transaction; and

(iii) Any reduction of specified policy acquisition expenses pursuant to an election under §1.848-2(i)(4) (relating to an assumption reinsurance transaction with an insolvent insurance company) is disregarded.

(D) *Examples.* The following examples illustrate the principles of this paragraph (g)(5)(ii):

Example 1. (i) *Facts.* On January 15, 2006, P acquires all of the stock of T, an insurance company, in a qualified stock purchase and makes a section 338 election for T. T issues individual life insurance contracts which are specified insurance contracts as defined in section 848(e)(1). P and new T are calendar year taxpayers. Under §§1.338-6 and 1.338-11(b)(2), the amount of AGUB allocated to old T's individual life insurance contracts is \$300,000. On the acquisition date, the tax reserves for old T's individual life insurance contracts are \$2,000,000. After the acquisition date, new T receives \$1,000,000 of net premiums with respect to new and renewal individual life insurance contracts and incurs \$100,000 of general deductions under 848(c)(2) through December 31, 2006. New T engages in no other reinsurance transactions other than the assumption reinsurance transaction treated as occurring by reason of the section 338 election.

(ii) *Analysis.* The transfer of insurance contracts and the assumption of related liabilities deemed to occur by reason of the election under section 338 is treated as an assumption reinsurance transaction. New T determines the adjusted basis under section 197(f)(5) for the life insurance contracts acquired in the assumption reinsurance transaction as follows. The amount paid or incurred for the individual life insurance contracts is \$300,000. To determine the amount required to be capitalized under section 848 in connection with the assumption reinsurance transaction, new T compares the required capitalization amount for the assumption reinsurance transaction with the general deductions allocable to the transaction. The required capitalization amount for the assumption reinsurance transaction is \$130,900, which is determined by multiplying the \$1,700,000 net positive consideration for the transaction (\$2,000,000 reinsurance premium less \$300,000 ceding commission) by the applicable percentage under section 848(c)(1) for the acquired individual

life insurance contracts (7.7%). To determine its general deductions, new T takes into account a tentative amortization deduction under section 197(a) as if the entire amount paid or incurred for old T's individual life insurance contracts (\$300,000) were allocable to an amortizable section 197 intangible with respect to insurance contracts acquired in the assumption reinsurance transaction. Accordingly, for the year of the assumption reinsurance transaction, new T is treated as having general deductions under section 848(c)(2) of \$120,000 (\$100,000 + \$300,000/15). Under §1.848-2(g)(6), these general deductions are first allocated to the \$77,000 capitalization requirement for new T's directly written business (\$1,000,000 x .077). Thus, \$43,000 (\$120,000 - \$77,000) of the general deductions are allocable to the assumption reinsurance transaction. Because the general deductions allocable to the assumption reinsurance transaction (\$43,000) are less than the required capitalization amount for the transaction (\$130,900), new T has a capitalization shortfall of \$87,900 (\$130,900 - \$43,000) with regard to the transaction. Under §1.848-2(g), this capitalization shortfall would cause old T to reduce the net negative consideration taken into account with respect to the assumption reinsurance transaction by \$1,141,558 (\$87,900 ÷ .077) unless the parties make the election under §1.848-2(g)(8) to capitalize specified policy acquisition expenses in connection with the assumption reinsurance transaction without regard to the general deductions limitation. If the parties make the election, the amount capitalized by new T under section 848 in connection with the assumption reinsurance transaction would be \$130,900. The \$130,900 capitalized by new T under section 848 would reduce new T's adjusted basis of the amortizable section 197 intangible with respect to the specified insurance contracts acquired in the assumption reinsurance transaction. Accordingly, new T would have an adjusted basis under section 197(f)(5) with respect to the individual life insurance contracts acquired from old T of \$169,100 (\$300,000 - 130,900). New T's actual amortization deduction under section 197(a) with respect to the amortizable section 197 intangible for insurance contracts acquired in the assumption reinsurance transaction would be \$11,273 (\$169,100 ÷ 15).

Example 2. (i) *Facts.* The facts are the same as *Example 1*, except that T only issues accident and health insurance contracts that are qualified long-term care contracts under section 7702B. Under section 7702B(a)(5), T's qualified long-term care insurance contracts are treated as guaranteed renewable accident and health insurance contracts, and, therefore, are considered specified insurance contracts under section 848(e)(1). Under §§1.338-6 and 1.338-11(b)(2), the amount of AGUB allocable to T's qualified long-term care insurance contracts is \$250,000. The amount of T's tax reserves for the qualified long-term care contracts on the acquisition date is \$7,750,000. Following the acquisition, new T receives net premiums of \$500,000 with respect to qualified long-term care contracts and incurs general deductions of \$75,000 through December 31, 2006.

(ii) *Analysis.* The transfer of insurance contracts and the assumption of related liabilities deemed to occur by reason of the election under section 338 is treated as an assumption reinsurance transaction.

New T determines the adjusted basis under section 197(f)(5) for the insurance contracts acquired in the assumption reinsurance transaction as follows. The amount paid or incurred for the insurance contracts is \$250,000. To determine the amount required to be capitalized under section 848 in connection with the assumption reinsurance transaction, new T compares the required capitalization amount for the assumption reinsurance transaction with the general deductions allocable to the transaction. The required capitalization amount for the assumption reinsurance transaction is \$577,500, which is determined by multiplying the \$7,500,000 net positive consideration for the transaction (\$7,750,000 reinsurance premium less \$250,000 ceding commission) by the applicable percentage under section 848(c)(1) for the acquired insurance contracts (7.7%). To determine its general deductions, new T takes into account a tentative amortization deduction under section 197(a) as if the entire amount paid or incurred for old T's insurance contracts (\$250,000) were allocable to an amortizable section 197 intangible with respect to insurance contracts acquired in the assumption reinsurance transaction. Accordingly, for the year of the assumption reinsurance transaction, new T is treated as having general deductions under section 848(c)(2) of \$91,667 (\$75,000 + \$250,000/15). Under §1.848-2(g)(6), these general deductions are first allocated to the \$38,500 capitalization requirement for new T's directly written business (\$500,000 x .077). Thus, \$53,167 (\$91,667 - \$38,500) of general deductions are allocable to the assumption reinsurance transaction. Because the general deductions allocable to the assumption reinsurance transaction (\$53,167) are less than the required capitalization amount for the transaction (\$577,500), new T has a capitalization shortfall of \$524,333 (\$577,500 - \$53,167) with regard to the transaction. Under §1.848-2(g), this capitalization shortfall would cause old T to reduce the net negative consideration taken into account with respect to the assumption reinsurance transaction by \$6,809,519 (\$524,333 ÷ .077) unless the parties make the election under §1.848-2(g)(8) to capitalize specified policy acquisition expenses in connection with the assumption reinsurance transaction without regard to the general deductions limitation. If the parties make the election, the amount capitalized by new T under section 848 in connection with the assumption reinsurance transaction would increase from \$53,167 to \$577,500. Pursuant to §1.197-2(g)(5)(ii)(C)(4), the additional \$524,333 (\$577,500 - \$53,167) capitalized by new T under section 848 would reduce new T's adjusted basis of the amortizable section 197 intangible with respect to the insurance contracts acquired in the assumption reinsurance transaction. Accordingly, new T's adjusted basis of the section 197 intangible with regard to the insurance contracts is reduced from \$196,833 (\$250,000 - \$53,167) to \$0. Because the additional \$524,333 capitalized pursuant to the §1.848-2(g)(8) election exceeds the \$196,833 adjusted basis of the section 197 intangible before the reduction, new T is required to reduce its deductions under section 805 by the \$327,500 (\$524,333 - 196,833).

(E) *Effective date.* This section applies to acquisitions and dispositions of insurance contracts on or after April 10, 2006.

The applicability of this section expires on or before April 7, 2009.

(g)(5)(iii) through (l) [Reserved]. For further guidance, see §1.197-2(g)(5)(iii) through (l).

Par. 5. Section 1.338-0 is amended by adding entries to the outline of topics for §1.338-11, §1.338-11T and §1.338(i)-1 to read as follows:

§1.338-0 Outline of topics.

* * * * *

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

- (a) In general.
- (b) Computation of ADSP and AGUB.
 - (1) Reserves taken into account as a liability.
 - (2) Allocation of ADSP and AGUB to specific insurance contracts.
- (c) Application of assumption reinsurance principles.
 - (1) In general.
 - (2) Reinsurance premium.
 - (3) Ceding commission.
- (d) Reserve increases by new target after the deemed asset sale.
- (e) Effect of section 338 election on section 846(e) election.
- (f) Effect of section 338 election on old target's capitalization amounts under section 848.
 - (1) Determination of net consideration for specified insurance contracts.
 - (2) Determination of capitalization amount.
 - (3) Section 381 transactions.
- (g) Effect of section 338 election on policyholders surplus account.
- (h) Effect of section 338 election on section 847 special estimated tax payments.

§1.338-11T Effect of section 338 election on insurance company targets (temporary).

- (a) through (c) [Reserved].
- (d) Reserve increases by new target after the deemed asset sale.
 - (1) In general.
 - (2) Exceptions.
 - (3) Amount of additional premium.
- (i) In general.

- (ii) Increases in unpaid loss reserves.
- (iii) Increases in other reserves.
- (4) Limitation on additional premium.
- (5) Treatment of additional premium under section 848.
 - (6) Examples.
 - (7) Effective dates.
 - (i) In general.
 - (ii) Application to pre-effective date increases to reserves.
 - (e) Effect of section 338 election on section 846(e) election.
 - (1) In general.
 - (2) Revocation of existing section 846(e) election.
 - (f) through (h) [Reserved].

§1.338(i)-1 Effective dates.

- (a) In general.
- (b) Section 338(h)(10) elections for S corporation targets.
- (c) Section 338 elections for insurance company targets.
 - (1) In general.
 - (2) New target election for retroactive election.
 - (i) Availability of election.
 - (ii) Time and manner of making the election for new target.
 - (3) Old target election for retroactive election.
 - (i) Availability of election.
 - (ii) Time and manner of making the election for old target.

Par. 6. Section 1.338-1 is amended by:

1. Revising the last two sentences of paragraph (a)(2).
2. Adding a sentence before the last sentence of paragraph (a)(3).
3. Redesignating existing paragraph (b)(2)(vii) as paragraph (b)(2)(viii) and adding new paragraph (b)(2)(vii).

The revisions read as follows:

§1.338-1 General principles; status of old target and new target.

- (a) * * *
- (2) * * * For example, if the target is an insurance company for which a section 338 election is made, the deemed asset sale results in an assumption reinsurance transaction for the insurance contracts deemed transferred from old target to new target. See, generally, §1.817-4(d), and for special rules regarding the acquisition of insurance company targets, §1.338-11.

(3) *** Section 1.338-11 provides special rules for insurance company targets.
* * *
* * * * *
(b) * * *
(2) * * *
(vii) [Reserved].
* * * * *

Par. 7. Section 1.338-1T is added to read as follows:

§1.338-1T General principles; status of old target and new target (temporary).

(a) through (b)(2)(vi) For further guidance, see §1.338-1(a) through (b)(2)(vi).
(b)(2)(vii) Section 846(e) (relating to an election to use an insurance company's historical loss payment pattern).

Par. 8. Section 1.338-11 is added to read as follows:

§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 \$17, 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 1001, 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 \times 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 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), \$56 to the securities (Class II), \$0 to the equipment (Class V), \$0 to the life insurance contract (Class VI), and \$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 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 ($\$50 \times 7.7\%$) under sec-

tion 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 reinsures at a loss, the acquired life insurance contract.

(d) *Reserve increases by new target after the deemed asset sale.* For further guidance, see §1.338-11T(d).

(e) *Effect of section 338 election on section 846(e) election.* For further guidance, see §1.338-11T(e)

(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).

(h) *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(3) 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.

Par. 9. Section 1.338-11T is added to read as follows:

§1.338-11T Effect of section 338 election on insurance company targets (temporary).

(a) through (c) [Reserved]. For further guidance, see §1.338-11(a) through (c).

(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), in the assumption reinsurance transaction described in

§1.338-11(c)(1). 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)(ii) and 1.338-7. Old target has no deduction under this paragraph (d) and makes no adjustments under §§1.338-4(b)(2)(ii) and 1.338-7.

(2) *Exceptions.* New target is not treated as receiving additional premium under paragraph (d)(1) 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). However, the additional premium cannot exceed the limitation described in paragraph (d)(4).

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

(1) A equals old target's discounted unpaid losses (determined under section 846) included in AGUB under §1.338-11(b)(1);

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

(3) 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; and

(4) 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

(5) 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) 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)(ii) and (iii) 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 \$80. 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 §1.338-11(b)(1), 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 \$475, D equals \$425 ($\$625 - \200), and E equals \$0. Under this formula, new T is treated as having increased its reserves for discounted unpaid losses attributable to losses incurred by old T by \$40 ($\$500/\$625 \times (\$475 - [\$425 + 0])$). The limitation under paragraph (d)(5) 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 those 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)(3) 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 \$50 ($\$625 - \575), and E equals \$50 ($\40 divided by .8). Under paragraph (d)(3) of this section, new T is treated as increasing its reserves for discounted unpaid losses by \$40 during 2007 with respect to losses incurred by old T ($\$500/\$625 \times (\$150 - [\$50 + \$50])$). 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 on 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 in-

curring 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 of paragraph (d)(3) of this section, where A equals \$500, B equals \$625, C equals \$0, and D equals -\$150 ($\$625 - (\$575 + \$200)$), and E equals \$100 ($\$80$ divided by .8). Thus, new T is treated as having increased its discounted unpaid losses by \$40 in 2008 with respect to losses incurred by old T before the acquisition date ($\$500/\$625 \times (0 - [-\$150 + \$100])$). New T includes this positive amount in gross income, subject to the limitation of paragraph (d)(4). The limitation of paragraph (d)(4) 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) is reduced to zero.

(7) *Effective dates—(i) 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. The applicability of the section expires on or before April 7, 2009.

(ii) *Application to pre-effective date increases to reserves.* If either new target makes an election under §1.338(i)-1(c)(2) or old target makes an election under §1.338(i)-1(c)(3) to apply the rules of §1.338-11, 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 §1.338-1T(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 in-

cludes 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) through (h) [Reserved]. For further guidance, see §1.338-11(f) through (h).

Par. 10. Section 1.338(i)-1 is amended by adding new paragraph (c) to read as follows:

§1.338(i)-1 Effective dates.

* * * * *

(c) *Section 338 elections for insurance company targets—(1) In general.* The rules of §1.338-11 apply to qualified stock purchases occurring on or after April 10, 2006.

(2) *New target election for retroactive application—(i) Availability of election.* New target may make an irrevocable election to apply the rules in §§1.338-11 and 1.338-11T(d) (including the applicable provisions in §§1.197-2(g)(5), 1.197-2T(g)(5)(ii), 381(c)(22)-1, and 846) in whole, but not in part, to a qualified stock purchase occurring before April 10, 2006, for which a section 338 election is made, provided that new target's first taxable year and all subsequent affected taxable years are years for which an assessment of deficiency or a refund for overpayment is not prevented by any law or rule of law. In the case of a section 338 election for which a section 338(h)(10) election is made (or a section 338 election for a foreign target), new target may make the election to apply the regulations retroactively without regard to whether old target makes the election. In the case of a section 338 election for a domestic target for which no section 338(h)(10) election is made, new target may make the election to apply the regulations retroactively only if old target also makes the election. Para-

graph (c)(2)(ii) of this section prescribes the time and manner of the election for new target.

(ii) *Time and manner of making the election for new target.* New target may make an election described in paragraph (c)(2)(i) of this section by attaching a statement to its original or amended income tax return for its first taxable year. The statement must be entitled "ELECTION TO RETROACTIVELY APPLY THE RULES IN §§1.338-11 and 1.338-11T(d) (INCLUDING THE APPLICABLE PROVISIONS IN §§1.197-2(g)(5), 1.197-2T(g)(5)(ii), 1.381(c)(22)-1 and 846) IN WHOLE TO A TRANSACTION COMPLETED BEFORE APRIL 10, 2006" and must include the following information—

(A) The name and E.I.N. for new target; and

(B) The following declaration (or a substantially similar declaration): NEW TARGET HAS AMENDED ITS INCOME TAX RETURNS FOR ITS FIRST TAXABLE YEAR AND FOR ALL AFFECTED SUBSEQUENT YEARS TO REFLECT THE RULES IN §§1.338-11 and 1.338-11T(d) (INCLUDING THE APPLICABLE PROVISIONS IN §§1.197-2(g)(5), 1.197-2T(g)(5)(ii), 1.381(c)(22)-1 and 846). ALL OTHER PARTIES WHOSE INCOME TAX LIABILITIES ARE AFFECTED BY NEW TARGET'S ELECTION HAVE AMENDED THEIR INCOME TAX RETURNS FOR ALL AFFECTED YEARS TO REFLECT THE RULES IN §§1.338-11 and 1.338-11T(d) (INCLUDING THE APPLICABLE PROVISIONS IN §§1.197-2(g)(5), 1.197-2T(g)(5)(ii), 1.381(c)(22)-1 and 846).

(3) *Old target election for retroactive application—(i) Availability of election.* Old target may make an irrevocable election to apply THE RULES IN §§1.338-11 and 1.338-11T(d) (INCLUDING THE APPLICABLE PROVISIONS IN §§1.197-2(g)(5), 1.197-2T(g)(5)(ii), 1.381(c)(22)-1 and 846) in whole, but not in part, to a qualified stock purchase occurring before April 10, 2006, for which a section 338 election is made, provided that old target's taxable year that includes the deemed sale tax consequences and all subsequent affected taxable years are years for which an assessment of deficiency or a refund for overpayment is not

prevented by any law or rule of law. In the case of a section 338 election for which a section 338(h)(10) election is made (or a section 338 election for a foreign target), old target may make the election to apply the regulations retroactively without regard to whether new target makes the election. In the case of a section 338 election for a domestic target for which no section 338(h)(10) election is made, old target may make the election to apply the regulations retroactively only if new target also makes the election. Paragraph (c)(3)(ii) of this section prescribes the time and manner of the election for old target.

(ii) *Time and manner of making the election for old target.* Old target may make an election described in paragraph (c)(3)(i) of this section by attaching a statement to each affected party's original or amended income tax return for the taxable year that includes the deemed sale tax consequences. The statement must be entitled "ELECTION TO RETROACTIVELY APPLY THE RULES IN §§1.338-11 and 1.338-11T(d) (INCLUDING THE APPLICABLE PROVISIONS IN §§1.197-2(g)(5), 1.197-2T(g)(5)(ii), 1.381(c)(22)-1 and 846) TO A TRANSACTION COMPLETED BEFORE APRIL 10, 2006" and must include the following information—

(A) The name and E.I.N. for old target; and

(B) The following declaration (or a substantially similar declaration): OLD TARGET HAS AMENDED ITS INCOME TAX RETURNS FOR THE TAXABLE YEAR THAT INCLUDES THE DEEMED SALE TAX CONSEQUENCES AND FOR ALL AFFECTED SUBSEQUENT YEARS TO REFLECT THE RULES IN §§1.338-11 and 1.338-11T(d) (INCLUDING THE APPLICABLE PROVISIONS IN §§1.197-2(g)(5), 1.197-2T(g)(5)(ii), 1.381(c)(22)-1 and 846). ALL OTHER PARTIES WHOSE INCOME TAX LIABILITIES ARE AFFECTED BY OLD TARGET'S ELECTION HAVE AMENDED THEIR INCOME TAX RETURNS FOR ALL AFFECTED YEARS TO REFLECT THE RULES IN §§1.338-11 and 1.338-11T(d) (INCLUDING THE APPLICABLE PROVISIONS IN §§1.197-2(g)(5), 1.197-2T(g)(5)(ii), 1.381(c)(22)-1 and 846).

Par. 11. Section 1.381(c)(22)-1 is amended by:

1. Revising the first sentence of paragraph (a).

2. Adding a sentence to the end of paragraph (b)(7)(i).

3. Redesignating existing (b)(7)(ii) as paragraph (b)(7)(iv) and adding new paragraphs (b)(7)(ii) and (b)(7)(iii).

4. Adding paragraphs (b)(7)(v), (b)(13), (b)(14), and (c).

The revisions read as follows:

§1.381(c)(22)-1 Successor insurance company.

(a) *Carryover requirement.* If in a taxable year beginning after December 31, 1957, a distributor or transferor corporation which is an insurance company is acquired by a corporation which is an insurance company in a transaction to which section 381(a) applies, section 381(c)(22) provides that the acquiring corporation shall take into account the appropriate items which the distributor or transferor corporation was required to take into account for purposes of part I, subchapter L, chapter 1 of the Internal Revenue Code.

* * *

(b) * * *

(7)(i) * * * However, any amounts attributable to money or other property not permitted to be received without the recognition of gain (*i.e.*, boot) distributed to a person other than the acquiring corporation under section 381(a) shall be treated as a distribution under section 815.

(ii) Notwithstanding paragraph (b)(7)(i) of this section, if the distributor or transferor corporation distributes or transfers less than 50 percent of its insurance business to the acquiring corporation, then the acquiring corporation shall succeed to a ratable portion of the dollar balances in the distributor's or transferor's shareholders surplus account, policyholders surplus account, and other accounts. The percentage of the accounts to which the acquiring corporation succeeds is determined by the ratio of the distributor's or transferor's insurance reserves for the contracts transferred to the acquiring corporation, as maintained under section 816(b), to the distributor's or transferor's reserves for all of its contracts maintained under section 816(b) immediately before the earlier of the distribution or transfer or the adoption of the

plan of liquidation or reorganization. For transactions in which the distributor liquidates pursuant to an election under section 338(h)(10), see §1.338-11(f) for the treatment of its remaining policyholders surplus account. For all other transactions subject to this paragraph, the distributor or transferor must take into account as income its remaining policyholders surplus account to the extent the fair market value of its assets (net of liabilities) distributed or transferred to the acquiring corporation or to the transferor's shareholders pursuant to the plan of liquidation or reorganization exceeds the distributor's or transferor's remaining shareholders surplus account.

(iii) If, pursuant to a plan in existence at the time of the liquidation or reorganization, the acquiring corporation transfers any insurance or annuity contract it received in the liquidation or reorganization to another person, then, for purposes of paragraph (b)(7)(ii) of this section, that contract shall be deemed to have been transferred by the transferor to that other person after the adoption of the plan of liquidation or reorganization. If the transferor is an old target within the meaning of §1.338(h)(10)-1(d)(2), any transfer by the acquiring corporation to the purchasing corporation (as defined in §1.338-2(c)(11)) or to any person related to the purchasing corporation within the meaning of section 197(f)(9)(C) within two years of the transfer described in section 381(a) will be presumed to have been pursuant to a plan in existence at the time of the liquidation or reorganization.

* * * * *

(v) The provisions of this paragraph (b)(7) are illustrated by the following examples:

Example 1. P buys the stock of insurance company target, T, from S for \$16, and P and S make a section 338(h)(10) election for T. T transfers no insurance contracts to S, or any related party, in connection with the transaction. Further, assume that T had \$10 in its policyholders surplus account and no balance in its shareholders surplus account or other accounts. Immediately before the deemed asset sale, old T is required to include as ordinary income the \$10 in the policyholders surplus account.

Example 2. Assume the same facts as in *Example 1*, except that T holds a block of life insurance contracts P does not wish to acquire, and, immediately before the sale of T stock, S causes T to distribute the unwanted block of insurance contracts to S. Further, assume that S is an insurance company, that the distribution of contracts is one of series of distributions in complete cancellation or redemption of all of its stock

(the others occurring under §1.338(h)(10)–1(d)(4)(i)) that qualifies as a complete liquidation under section 332, and that old T's tax reserves with respect to the distributed contracts represent one-tenth of old T's tax reserves with respect to all of its life insurance contracts. Because T transfers less than 50 percent of its life insurance business to S in a transaction to which section 381(a) applies, S succeeds to a ratable portion of old T's policyholders surplus account (\$1), and old T includes as ordinary income the remaining \$9 of that account.

Example 3. Assume the same facts as in *Example 2*, except that 14 months after the deemed asset sale, S and X, a person related to new T under section 197(f)(9)(C), engage in an indemnity reinsurance transaction involving the contracts transferred to S from old T. Because X is related to the purchasing corporation (P) under section 197(f)(9)(C), and X receives contracts from the acquiring corporation (S) that S acquired from old T within two years of the transfer from old T to S, the contracts are presumed to have been transferred pursuant to a plan in existence at the time of old T's liquidation. If S cannot establish otherwise, old T is treated as having distributed the remainder of its policyholders surplus account. In that case, in the taxable year of the indemnity reinsurance transaction, S takes into account as ordinary income the portion of old T's accounts (\$9) that old T or S has not previously taken into account as income.

* * * * *

(13)(i) The transferor's unamortized policy acquisition expenses or positive or negative capitalization requirements on its specified insurance contracts.

(ii) Notwithstanding paragraph (b)(13)(i) of this section, if the distributor or transferor corporation transfers less than 50 percent of its insurance business to the acquiring corporation, then the acquiring corporation shall succeed to a ratable portion of the transferor's unamortized policy acquisition expenses or positive or negative capitalization requirements on its specified insurance contracts. The percentage of such acquisition expenses or positive or negative capitalization requirements to which the acquiring corporation succeeds is determined by the ratio of the distributor's or transferor's insurance reserves for the contracts transferred to the acquiring corporation, as maintained under section 816(b), to the distributor's or transferor's reserves for all of its contracts maintained under section 816(b) immediately before the earlier of the distribution or transfer or the adoption of the plan of liquidation or reorganization. For amounts of the distributor's or transferor's unamortized policy acquisition expenses or positive or negative capitalization requirements on its specified insurance contracts to which the acquirer does not succeed to

under this paragraph, and, for transactions in which the transferor liquidates pursuant to an election under section 338(h)(10), see §1.338–11(f) for the treatment of its capitalized amounts under section 848.

(iii) If, pursuant to a plan in existence at the time of the liquidation or reorganization, the acquiring corporation transfers any insurance or annuity contract it received in the liquidation or reorganization to another person, then, for purposes of paragraph (b)(13)(ii) of this section, that contract shall be deemed to have been transferred by the transferor to that other person after the adoption of the plan of liquidation or reorganization. If the transferor is an old target within the meaning of §1.338(h)(10)–1(d)(2), any transfer by the acquiring corporation to the purchasing corporation (as defined in §1.338–2(c)(11)) or to any person related to the purchasing corporation within the meaning of section 197(f)(9)(C) within two years of the transfer described in section 381(a) will be presumed to have been pursuant to a plan in existence at the time of the liquidation or reorganization.

(14) The special loss discount account, provided, however, that the acquiring corporation will succeed to the special loss discount account only to the extent that it is attributable to the portion of the transferor's insurance business acquired by the acquiring corporation in the section 381 transaction.

(c) *Effective dates*—(1) *In general.* This section applies to the acquisition of assets of an insurance company by another insurance company in a transaction to which section 381 applies for taxable years beginning after December 31, 1957.

(2) *Special rules for section 381 transactions.* Paragraphs (a), (b)(7), (b)(13), and (b)(14) of this section apply to the acquisition of assets of an insurance company by another insurance company in a transaction to which section 381 applies on or after April 10, 2006.

(3) *Joint retroactive election.* The distributor or transferor and the acquiring corporation may jointly make an irrevocable election to apply paragraphs (a), (b)(7), (b)(13), and (b)(14) of this section to a transaction to which section 381 applies occurring before April 10, 2006, provided that the taxable year that includes the acquisition and all subsequent affected taxable years of both the distributor or

transferor and the acquiring corporation are years for which an assessment of deficiency or a refund for overpayment is not prevented by any law or rule of law.

(4) *Time and manner of making the joint election.* The distributor or transferor and the acquiring corporation may make an election described in paragraph (c)(2) of this section by each attaching a statement to its original or amended income tax return for the taxable year that includes the acquisition of assets in a transaction to which section 381 applies. The statement must be entitled "ELECTION TO RETROACTIVELY APPLY THE RULES OF SECTION 1.381(c)(22)–1 TO A TRANSACTION COMPLETED BEFORE APRIL 10, 2006" and must include the following information—

(i) The name and E.I.N. of the distributor or transferor and the acquiring corporation; and

(ii) The following declaration (or a substantially similar declaration): THE DISTRIBUTOR OR TRANSFEROR AND THE ACQUIRING CORPORATION HAVE EACH AMENDED ITS INCOME TAX RETURNS FOR THE TAXABLE YEAR THAT INCLUDES THE ACQUISITION OF ASSETS IN A TRANSACTION TO WHICH SECTION 381 APPLIES AND FOR ALL AFFECTED SUBSEQUENT YEARS TO REFLECT THE RULES IN PARAGRAPHS (a), (b)(7), (b)(13), and (b)(14) OF SECTION 1.381(c)(22)–1.

* * * * *

Par. 12. Section 1.846–0 is amended by:

1. Adding a new entry in the table of contents for §1.846–2(d).

2. Revising the entry in the table of contents for §1.846–4.

3. Adding a new entry in the table of contents for §1.846–4T.

The revisions and additions read as follows:

§1.846–0 *Outline of provisions.*

* * * * *

§1.846–2 *Election by taxpayer to use its own historical loss payment pattern.*

* * * * *

(d) Effect of section 338 election on section 846(e) election.

§1.846-2T Election by taxpayer to use its own historical loss payment pattern (temporary).

(a) through (c) [Reserved].

(d) Effect of section 338 election on section 846(e) election.

§1.846-4 Effective dates.

(a) In general.

(b) Section 338 election.

§1.846-4T Effective dates (temporary).

(a) [Reserved].

(b) Section 338 election.

Par. 13. Section 1.846-2 is amended by adding paragraph (d) to read as follows:

§1.846-2 Election by taxpayer to use its own historical loss payment pattern.

(d) *Effect of section 338 election on section 846(e) election.* [Reserved]. For further guidance, see §1.846-2T(d).

Par. 14. Section 1.846-2T is added to read as follows:

§1.846-2T Election by taxpayer to use its own historical loss payment pattern (temporary).

(a) through (c) [Reserved]. For further guidance, see §1.846-2(a) through (c).

(d) *Effect of section 338 election on section 846(e) election.* For rules regarding qualified stock purchases occurring on or after April 10, 2006, see §§1.338-1(b)(2)(vii) and 1.338-11T(e).

Par. 15. Section 1.846-4 is revised to read as follows:

§1.846-4 Effective dates.

(a) *In general.* Sections 1.846-1 through 1.846-3 apply to taxable years beginning after December 31, 1986.

(b) *Section 338 election.* [Reserved]. For further guidance, see §1.846-2T(d).

Par. 16. Section 1.846-4T is added to read as follows:

1.846-4T Effective dates (temporary).

(a) [Reserved]. For further guidance, see §1.846-2(a).

(b) *Section 338 election.* Section 1.846-2(d) applies to section 846(e) elections made with regard to a qualified stock purchase made on or after April 10, 2006.

Par. 17. Section 1.1060-1 is amended by:

1. Revising paragraph (a)(2).

2. Adding new entries in paragraph (a)(3) in the outline of topics for paragraphs (b)(9) and (c)(5).

3. Adding new paragraphs (b)(9) and (c)(5).

The revision and additions read as follows:

§1.1060-1 Special allocation rules for certain asset acquisitions.

(a) *****

(2) *Effective dates*—(i) *In general.* The provisions of this section apply to any asset acquisition occurring after March 15, 2001. However, paragraphs (b)(9) and (c)(5) of this section apply only to applicable asset acquisitions occurring on or after April 10, 2006. A purchaser or a seller may make an irrevocable election to apply the rules in §§1.338-11 and 1.338-11T(d) (including the applicable provisions in §§1.197-2(g)(5), 1.197-2T(g)(5)(ii), 1.381(c)(22)-1, 846 and 1060) to an applicable asset acquisition occurring before April 10, 2006. Paragraph (a)(2)(ii) of this section describes the time and manner of the election for the purchaser and paragraph (a)(2)(iii) of this section prescribes the time and manner of the election for the seller. The seller may make the election to apply the regulations retroactively without regard to whether the purchaser also makes the election. For rules applicable to asset acquisitions on or before March 15, 2001, see §1.1060-1T in effect before March 16, 2001 (see 26 CFR part 1 revised April 1, 2000).

(ii) *Time and manner of making the election for the purchaser.* The purchaser may make an election described in this paragraph (a)(2) by attaching a statement to its original or amended income tax return for the taxable year that includes the applicable asset sale. The statement must

be entitled “ELECTION TO RETROACTIVELY APPLY THE RULES IN §§1.338-11 and 1.338-11T(d) (INCLUDING THE APPLICABLE PROVISIONS IN §§1.197-2(g)(5), 1.197-2T(g)(5)(ii), 1.381(c)(22)-1, 846 and 1060) TO AN APPLICABLE ASSET ACQUISITION COMPLETED BEFORE APRIL 10, 2006” and must include the following information—

(A) The name and E.I.N. for the purchaser; and

(B) The following declaration (or a substantially similar declaration): THE PURCHASER HAS AMENDED ITS INCOME TAX RETURNS FOR THE TAXABLE YEAR THAT INCLUDES THE APPLICABLE ASSET ACQUISITION AND FOR ALL AFFECTED SUBSEQUENT YEARS TO REFLECT THE RULES IN §§1.338-11 and 1.338-11T(d) (INCLUDING THE APPLICABLE PROVISIONS IN §§1.197-2(g)(5), 1.197-2T(g)(5)(ii), 1.381(c)(22)-1, 846 and 1060).

(iii) *Time and manner of making the election for the seller.* The seller may make an election described in this paragraph (a)(2) by attaching a statement to its original or amended income tax return for the taxable year that includes the applicable asset sale. The statement must be entitled “ELECTION TO RETROACTIVELY APPLY THE RULES IN §§1.338-11 and 1.338-11T(d) (INCLUDING THE APPLICABLE PROVISIONS IN §§1.197-2(g)(5), 1.197-2T(g)(5)(ii), 1.381(c)(22)-1, 846 and 1060) TO AN APPLICABLE ASSET ACQUISITION COMPLETED BEFORE APRIL 10, 2006” and must include the following information—

(A) The name and E.I.N. for the seller; and

(B) The following declaration (or a substantially similar declaration): THE SELLER HAS AMENDED ITS INCOME TAX RETURNS FOR THE TAXABLE YEAR THAT INCLUDES THE APPLICABLE ASSET ACQUISITION AND FOR ALL AFFECTED SUBSEQUENT YEARS TO REFLECT THE RULES IN §§1.338-11 and 1.338-11T(d) (INCLUDING THE APPLICABLE PROVISIONS IN §§1.197-2(g)(5), 1.197-2T(g)(5)(ii), 1.381(c)(22)-1, 846 and 1060).

(3) *****

* * * * *

(b) * * *

(9) Insurance Business.

(c) * * *

(5) Insurance Business.

* * * * *

(b) * * *

(9) *Insurance business.* The mere reinsurance of insurance contracts by an insurance company is not an applicable asset acquisition, even if it enables the reinsurer to establish a customer relationship with the owners of the reinsured contracts. However, a transfer of an insurance business is an applicable asset acquisition if the purchaser acquires significant business assets, in addition to insurance contracts, to which goodwill and going concern value could attach. For rules regarding the treatment of an applicable asset acquisition of an insurance business, see paragraph (c)(5) of this section.

(c) * * *

(5) *Insurance business.* If the trade or business transferred is an insurance business, the rules of this paragraph (c) are modified by the principles of §1.338-11(a) through (d). However, in transactions governed by section 1060, such principles apply even if the transfer of the trade or business is effected in whole or in part through indemnity reinsurance rather than assumption reinsurance, and, for the insurer or reinsurer, an insurance contract (including an annuity or reinsurance contract) is a Class VI asset regardless of whether it is a section 197 intangible. In addition, the principles of §1.338-11(f) through (h) apply if the transfer occurs in connection with the complete liquidation of the transferor.

* * * * *

PART 602—OMB CONTROL NUMBERS UNDER PAPERWORK REDUCTION ACT

Par. 18. The authority citation for part 602 continues to read as follows:

Authority: 26 U.S.C. 7805. * * *

Par. 19. In §602.101, paragraph (b) is amended by revising the entry for “1.1060-1” and adding the following entries in numerical order to the table to read as follows:

§602.101 OMB Control numbers.

* * * * *

(b) * * *

CFR part or section where identified and described	Current OMB control No.
* * * * *	
1.338-11T * * * * *	1545-1990
1.338(i)-1 * * * * *	1545-1990
1.381(c)(22)-1 * * * * *	1545-1990
1.1060-1 * * * * *	1545-1658 1545-1990

Mark E. Matthews,
Deputy Commissioner for Services and Enforcement.

Approved March 7, 2006.

Eric Solomon,
Acting Deputy Assistant Secretary of the Treasury (Tax Policy).

(Filed by the Office of the Federal Register on April 7, 2006, 8:45 a.m., and published in the issue of the Federal Register for April 10, 2006, 71 F.R. 17990)

Section 472.—Last-in, First-out Inventories

26 CFR 1.472-1: Last-in, first-out inventories.

LIFO; price indexes; department stores. The February 2006 Bureau of Labor Statistics price indexes are accepted for use by department stores employing the retail inventory and last-in, first-out inventory methods for valuing inventories for tax years ended on, or with reference to, February 28, 2006.

Rev. Rul. 2006-23

The following Department Store Inventory Price Indexes for February 2006 were issued by the Bureau of Labor Statistics.

The indexes are accepted by the Internal Revenue Service, under § 1.472-1(k) of the Income Tax Regulations and Rev. Proc. 86-46, 1986-2 C.B. 739, for appropriate application to inventories of department stores employing the retail inventory and last-in, first-out inventory methods for tax years ended on, or with reference to, February 28, 2006.

The Department Store Inventory Price Indexes are prepared on a national basis and include (a) 23 major groups of departments, (b) three special combinations of the major groups — soft goods, durable goods, and miscellaneous goods, and (c) a store total, which covers all departments, including some not listed separately, except for the following: candy, food, liquor, tobacco, and contract departments.