Proposed Regulations under I.R.C. §§ 338(h)(10) and 1060 as Applicable to Insurance Companies

The following comments represent the individual views of those members of the Section of Taxation who prepared them and do not represent the position of the American Bar Association or of the Section of Taxation.

These comments were prepared by individual members of the Committee on Insurance Companies of the Section of Taxation. Principal responsibility was exercised by Michael A. Bell and Christopher W. Schoen. Substantive contributions were made by R. Lee Christie and William M. Richardson. The comments were reviewed by Richard Bromley and John P. Barrie of the Section’s Committee on Government Submissions and by Stevie D. Conlon, Council Director for the Committee on Insurance Companies and Joseph M. Pari, Council Director of the Corporate Tax Committee.

Although many of the members of the Section of Taxation who participated in preparing these Comments have clients who would be affected by the federal tax principles addressed by these Comments or have advised clients on the application of such principles, no such member (or the firm or organization to which such member belongs) has been engaged by a client to make a government submission with respect to, or otherwise to influence the development or outcome of, the specific subject matter of these Comments.

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I. EXECUTIVE SUMMARY

We believe that the proposed regulations published by the Department of the Treasury (the "Treasury") and the Internal Revenue Service (the "Service") generally provide workable rules applicable to insurance companies in connection with elections under section 338(h)(10). In general, the Treasury and the Service have fashioned a system under § 338(h)(10) that gives insurance companies guidance in making elections thereunder. There are, however, some revisions that we request be considered.

We question whether the Treasury and the Service have the authority to impose the proposed loss reserve limitation rule that is provided in the proposed regulations. Regardless of whether they have such authority or not, the proposed loss reserve limitation rule appears to be founded on the erroneous premise that unpaid loss reserves are contingent liabilities, even though Congress and the Service itself have previously recognized that they are not. We believe that additions to unpaid loss reserves are distinguishable from contingent liabilities for federal income tax purposes and should not be subject to treatment similar to that of contingent liabilities under general federal income tax principles. Moreover, the proposed loss reserve limitation rule disregards insurance companies' bona fide need to increase reserves, and ignores the critical fact that increasing reserves simply in order to obtain a tax deduction would result in an adverse net economic loss for the insurance company. It appears to us that the proposed loss
reserve limitation rule might actually be intended to be an anti-abuse rule. If so, then it should be so structured as an anti-abuse rule and its application should be limited to cases of abuse. Unless rewritten as a more narrow anti-abuse rule, we recommend eliminating the proposed loss reserve limitation rule from the final regulations.

We further believe that the final regulations should clarify that treating an indemnity reinsurance transaction under the assumption reinsurance rules of Prop. Treas. Reg. § 1.338-11 is not intended to force an indemnity reinsurance transaction into capitalization under section 197, which otherwise does not apply. We understand that such treatment was never intended to result, and therefore a clarification should not be controversial.

We also believe that denying new target the opportunity to continue old target's historical payment pattern election under section 846(e) exalts form over substance and, considering the other exceptions that have been made to the "new corporation" rule under section 338(h)(10), we believe that such denial fails to serve an important tax policy. Therefore, we recommend that old target and new target be treated as the same corporation for purposes of the historical payment pattern election under section 846(e).

Finally, we believe that there should be clarification regarding the scope of the proposed regulations under section 1060.

II. DETAILED COMMENTS

On March 8, 2002, the Treasury and the Service issued proposed regulations under section 338(h)(10) of the Internal Revenue Code (the "Code"), which
have been drafted to give guidance to insurance companies that seek to join in an election under that provision. The purpose of the regulations project was to provide a structure of rules that would permit insurance companies to make elections under section 338(h)(10) as companies in other industries can. In general, we believe that the Treasury and the Service have done a good job of addressing the distinct but overlapping tax concepts and rules of subchapter C and subchapter L in this limited context and determining which rules should apply when a corporation makes a qualified stock purchase of an insurance company and makes a section 338(h)(10) election.

The proposed regulations provide long-needed answers to a number of questions that are unique, but important, to insurance companies. For example, the proposed regulations state that a section 338(h)(10) election involving an insurance company is to be treated as an assumption reinsurance transaction, thus providing the insurance industry with a procedure that it has known and generally used for many years. Noting that assumption reinsurance is used infrequently in the property and casualty insurance industry, some had expressed concern that employing an assumption reinsurance method in a section 338(h)(10) transaction could, in some circumstances, result in new target having to recognize income as a result of its (deemed) purchase, a result faced by no other industry. To alleviate that risk, the proposed regulations provide that the deemed consideration for the sale that is deemed to occur pursuant to section 338(h)(10) will be equal to the old target company's closing tax reserves on the date of the qualified stock purchase. We commend the Treasury and the Service for their thoughtful consideration in this regard.
In addition, following the Service's ruling precedents, the proposed regulations generally treat tax reserves as fixed liabilities, thus permitting them to be taken into account in determining adjusted deemed sales price and adjusted grossed up basis under section 338(h)(10). This position reflects both consistency and fairness, and we applaud the Treasury and the Service for adopting it. Finally, we commend the Treasury and the Service for providing in the proposed regulations that the deemed ceding commission under the assumption reinsurance transaction that is deemed to occur as a result of a section 338(h)(10) election is to be computed using a residual method.

There are other matters regarding the proposed regulations, however, that we believe the Treasury and the Service should consider. Three such matters, which we discuss below, are: (1) eliminating of the proposed loss reserve limitation rule; (2) allowing new target to be treated as the same corporation as old target for purposes of section 846(e) in cases where old target has made a valid election under that provision, and (3) clarifying the scope of the proposed regulations under section 1060.

A. **Proposed Loss Reserve Limitation Rule.** Generally speaking, the proposed loss reserve limitation rule in the proposed regulations effectively limits the deductions for additions to new target's unpaid loss reserves to 2% annually for the first four years after the section 338(h)(10) election.\(^1\) Rather than directly limiting the deduction for additions to loss reserves, however, Prop. Treas. Reg. § 1.338-11(d)(1)

\(^1\) The proposed loss reserve limitation rule does not apply to insurance companies that are in receivership, nor does it apply in the case of life insurance reserve increases that are amortized under section 807(f).
requires that new target include certain amounts in income as additional premium for the
assets acquired in the deemed reinsurance transaction that is deemed to occur as a result
of an election under section 338(h)(10). Briefly stated, the amount permitted as an
addition to post-transaction unpaid loss reserves for the first post-transaction taxable year
is: \[ \text{Old target's discounted unpaid losses} \div \text{old target's undiscounted unpaid losses} \times [\text{new
\text{target’s undiscounted unpaid losses attributable to old target’s unpaid losses as of the
acquisition date, reduced by } 1.02 \times \text{old target’s discounted unpaid losses – losses already
paid}] \]. Old target’s discounted unpaid losses would be multiplied by 1.04 for the second
year, 1.06 for the third year, and 1.08 for the fourth year. New target would receive
additional basis each year for the amount of the reserve increase for which it is
effectively denied a deduction, and new target would allocate the additional basis under
the residual method.

The Preamble states that post-acquisition increases in three types of tax
reserves with respect to acquired contracts could potentially be subject to capitalization
under the proposed regulations: increases of unpaid loss reserves attributable to changes
in loss estimates, increases of other reserves through changes in methodology or
assumptions, and increases of unpaid loss reserves as a result of reinsuring acquired
contracts at a loss.\(^2\) Prop. Treas. Reg. §1.338-11(d)(4) extends the proposed loss reserve
limitation rule to other reserves to the extent that the net aggregate increase in such

\(^2\) Note that the Preamble treats only \textit{additions} to unpaid loss reserves as contingent
liabilities. We are unaware of any authority that permits an unpaid loss reserve to be split into
two elements: one mature and one contingent.
reserves is caused by changes in methodology or changes in assumptions used to compute the reserves for those contracts (including cases in which new target's assumptions or methods are different from old target's assumptions or methods).³

There appear to be alternative rationales for the proposed loss reserve limitation rule, the first being analogous to treating additions to loss reserves as contingent liabilities,⁴ and the second being attributable to an idea that differently situated taxpayers should not derive different tax results from a given set of circumstances. We respectfully suggest that each of these rationales is flawed, and each fails to justify the proposed loss reserve limitation rule, as explained below. We therefore recommend that the Treasury and the Service eliminate the proposed loss reserve limitation rule from the final regulations.

1. The Authority of the Treasury and the Service to Impose a Proposed Loss Reserve Limitation Rule Is Questionable. One fundamental question that we have with the proposed loss reserve limitation rule is whether the Treasury and the Service have the regulatory authority to impose it. Although the proposed loss reserve limitation rule is described as a limitation on an affected insurance company's

³ As the proposed regulations are drafted, the reserves most likely to be affected by the rule are mentioned only in the Preamble. If the proposed loss reserve limitation rule is retained in the final regulation—and we strongly urge that it not be retained—the types of reserves to which the rule applies should be expressly stated in the regulation.

⁴ These comments regarding the treatment of contingent liabilities under section 338(h)(10) are not intended to address the tax treatment of contingent liabilities, nor any other provision of Subchapter C, outside the context of the regulations currently proposed under section 338(h)(10), (Reg-118861-00) proposed March 8, 2002.
deduction for increases to unpaid loss reserves, it is actually a requirement for new target
to include an amount in gross income. The Preamble states:

To the extent a reinsurer is required to capitalize reserve increases, the reinsurer must include such amount in gross income in the year of the increase to offset the deduction taken under section 832(b)(5) for the reserve increases. The reinsurer must include the amount to be capitalized in AGUB and treat such amount as additional premium received in the deemed asset sale as of the year of the adjustment.

Such a requirement would have new target recognizing income before it has been realized, and we question the Treasury's and the Service's authority to impose the requirement. The concept of realization is fundamental to our income tax system: except in certain specified and limited circumstances (such as statutorily enacted mark-to-market rules, for example) income must be realized before it can be subjected to tax. See, e.g., Cottage Savings Association v. Commissioner, 499 U.S. 554, 111 S. Ct. 1503 (1991); Commissioner v. Glenshaw Glass, 348 U.S. 426, 75 S. Ct. 473 (1955). We are unable to see how the amounts that new target would have to include in gross income under the proposed loss reserve limitation rule will have been realized.

2. **Unpaid Loss Reserves Are Not Contingent Liabilities.** We also believe that the proposed regulations err in treating unpaid loss reserves as contingent liabilities. We note neither the Preamble nor the proposed regulations contain a definition of the term *contingent*. We have therefore assumed for purposes of these

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5 The Preamble to the proposed regulations refers to "capitalization of unpaid loss reserve increases," but the proposed loss reserve limitation rule does not involve capitalization. Rather, it requires new target to take amounts into gross income.
comments that the term *contingent* is used in the ordinary tax sense, *i.e.*, with reference to a liability that will satisfy the all-events test only upon the occurrence of one or more future events. In that regard, it should be noted that insurance reserves are not subject to the all-events test, but rather arise based on the prior occurrence of a covered loss event.⁶


The Staff of the Joint Committee on Taxation has explained the nature of insurance reserves, and its explanation shows that unpaid loss reserves are not considered to be contingent:

Property and casualty insurers are permitted a deduction for losses incurred and expenses incurred during the taxable year in computing their underwriting income. Losses incurred are computed as the sum of losses paid (with appropriate adjustments for salvage and reinsurance recoverable) and the *net increase (or decrease) in unpaid losses*. The amount of unpaid losses which may be claimed is the amount which, at the close of the taxable year (based on the facts in each case and the company's experience in similar cases) represents a fair and reasonable estimate of the amount the company will be required to pay. The effect of this provision is to allow property and casualty insurers to claim deductions for reported losses, incurred but not reported (IBNR) losses, and

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⁶ Loss adjustment expenses are similarly taken into account on an estimated basis in the year in which the covered loss occurs, even though in that taxable year the services giving rise to the loss adjustment expenses have not yet been provided to the insurance company.
resisted or contested losses. A contingency reserve for events yet to occur remains nondeductible.


The last sentence quoted above is especially significant. An insurer's liability for covered claims depends on the occurrence of a loss event. Accordingly, additions to an unpaid loss reserve could never be contingent in the ordinary tax sense. The reserve is established based on a loss event. It is not contingent when established. Each year thereafter, when the insurer makes additions to the reserve, it must necessarily be true that the loss event occurred when the reserve was initially established. What it appears that the Treasury and the Service seek to limit is deductions for additions to a contingent reserve, and those are already entirely nondeductible under current law.

Moreover, the Service has repeatedly concluded that insurance reserves are not contingent in the context of an election under section 338. See Rev. Rul. 95-74, 1995-2 C.B. 36 (contingent liabilities assumed by subsidiary in section 351 exchange not treated as liabilities for purposes of section 358(d)); compare Rev. Rul. 94-45, 1994-2 C.B. 39 (insurance reserves assumed by a subsidiary in a section 351 exchange are treated as liabilities for purposes of section 358(d)).

The FSA is not clear about why the transaction constituted a qualified stock purchase. 8
The fair market value of the old targets' assets exceeded the sum of the old targets' insurance reserves and other liabilities plus the amount paid for the old targets' stock, and one of the questions addressed was whether new target was required to report the excess as income.

In the course of its analysis, the Service compared the result under general tax principles with the result under Subchapter L. Under general tax principles, the Service wrote, when an asset purchaser assumes a seller's contingent liability and then the contingent liability becomes fixed and determinable (i.e., when the contingent future event occurs and the liability satisfies the all events test), the asset purchaser would be entitled to increase its basis in the asset, but it would not be entitled to a deduction in respect of the (formerly) contingent liability.

Accordingly, the buyer of the business would not be entitled to a deduction upon payment of any contingent liabilities assumed as part of the purchase of the business, even though these liabilities would otherwise have constituted a deductible expense if the business had not changed hands. See, Pacific Transport Co. v. Commissioner, 483 F.2d 209 (9th Cir. 1973), cert. denied, 415 U.S. 948 (1974). [9]

In contrast, the Service wrote, under Subchapter L principles, a contingent liability assumed by an assuming company would not interfere with the basis of the assuming company in the assets received from the ceding company:

[U]nder subchapter L reinsurance rules, there is no delay placed on the assuming company in creating basis if the assets received from the ceding company represent the expected payment of contingent liabilities. Similarly, there is no tension between contingent liabilities assumed by the

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[9] Pacific Transport is one of the cases cited in the Preamble in support of the proposed loss reserve limitation rule.
buyer as part of the purchase of the business and post-sale liabilities incurred by the buyer. Thus, for example, if the assuming company were to determine that it was necessary to strengthen the unpaid loss reserves on the assumed business in a post-sales year to properly reflect the amount of liabilities assumed, the assuming company would be permitted to include the additional reserves (after discounting these amounts in accordance with section 846) in computing its deduction for losses incurred in the year in which the reserves are increased.

FSA 1998-476, supra (emphasis added). The use of Subchapter L rules in a section 338(h)(10) transaction involving insurance companies does not produce an anomalous result, the Service wrote:

To the contrary, the subchapter L approach may more clearly reflect the economics of the transaction than a rule requiring the capitalization of the buyer's payments of contingent liabilities assumed as part of the asset purchase. See, D. Halperin, Assumption of Contingent Liabilities on Sale of a Business, in Florida Tax Review, Vol. 2, No. 12 (1996).

Id. The same sentiment was expressed in FSA 2000-18-003, in which the Service wrote:

In a case where a company transfers its insurance business to another company in a cash merger, Subchapter L requires that as long as the merged company pays fair and reasonable consideration to the surviving company to assume its risks, the reinsurer should be entitled to revalue its losses each year in the same manner as any other insurance company.

Thus, in the instant case, the amount Taxpayer received (or is deemed to have received) from Company A to assume the latter's insurance liabilities, including liabilities for unpaid losses, constituted an insurance premium that Taxpayer was entitled to include in its reserve for unpaid losses, the Company A unpaid losses to which it succeeded on account of the merger; and that in Year 1 through Year 4, Taxpayer
was entitled to increase or decrease those reserves, as appropriate.\footnote{10}

\textit{See also} FSA 2000-18-004 (Dec. 12, 1999) (to the same effect); FSA 1999-1015 (Apr. 2, 1993) (to the same effect); \textit{cf.} LTR 87-47-004, in which the Service stated "It is this office's position . . . that the life insurance reserves [at issue] are to be treated as fixed and determinable" for purposes of section 334(b)(2).

3. \textbf{The Proposed Loss Reserve Limitation Rule is Inconsistent with Congressional Intent Regarding Subchapter L.} The Service has never, to our knowledge, attempted to apply the proposed loss reserve limitation rule to an actual reinsurance transaction, and there may be a reason why not. The Preamble to the proposed regulations states that:

\begin{quote}
The IRS and Treasury recognize that in the context of acquisitions of businesses other than insurance businesses, courts have held that when contingent liabilities assumed in connection with an asset acquisition mature, such liabilities, like fixed liabilities, must be capitalized as a cost of the acquired assets, even if those matured liabilities would have been currently deductible had they been incurred in the acquirer's own historic business. \textit{See Pacific Transport Co. v. Commissioner,} 483 F.2d 209, 214 (9th Cir. 1973), \textit{cert. denied,} 415 U.S. 948 (1974); \textit{Illinois Tool Works Inc. v. Commissioner,} 117 T.C. No. 4 (July 31, 2001). As a theoretical matter, in the context of acquisitions of insurance businesses, capitalization could be required, and deductions could be disallowed, for all post-acquisition increases in reserves that are attributable to liabilities under acquired insurance contracts that were contingent at the time of the acquisition.
\end{quote}

\footnote{10 In FSA 2000-18-003, the Service also stated that "\textit{Pacific Transport} is factually distinguishable from the instant case and should not be relied upon."}
The earliest of the cases cited was decided nearly 30 years ago, and nonetheless, the Service has never promulgated a regulation, issued a Notice, or even issued a private letter ruling or technical advice memorandum applying to a reinsurance transaction a limitation comparable to the proposed loss reserve limitation rule.

As reflected in the proposed regulations, the principle underlying the proposed loss reserve limitation rule is that post-transaction increases to unpaid loss reserves following the deemed assumption reinsurance transaction that occurs in connection with an election under section 338(h)(10) are partially contingent and that "such liabilities . . . must be capitalized." If that principle is correct, then it must follow that post-transaction increases to unpaid loss reserves following an actual assumption reinsurance transaction are partially contingent and must be capitalized, but we have been unable to find any record of such cases or rulings.

The absence of any such cases or rulings might be attributable to Congress's admonition during the passage of the Life Insurance Company Income Tax Act of 1959, Pub. L. No. 86-69, 73 Stat. 112, when Congress expressed its intent that Subchapter L override Subchapter C in the case of any conflict between the two. The Service has recently reiterated this general rule in a field service advice, "When the tax treatment of a transaction under Subchapter L conflicts with that provided under another provision of the Code, the tax treatment provided under Subchapter L generally will prevail." FSA 2000-18-004, supra, citing S. Rep. No. 291, 86th Cong., 1st Sess. 39 (1959), cited in 1959-2 C.B. 770, 798 (emphasis added).\textsuperscript{11}

\textsuperscript{11} Congress expressed its preference for Subchapter L over Subchapter C so that the Subchapter L rules would not be subsumed by the Subchapter C rules. Note, for example, that in mutual insurance companies (property and casualty insurance companies as well as life insurance (footnote continued)
This preference for Subchapter L rules in a conflict between Subchapter C (section 338) and Subchapter L (reserve accounting) is precisely the type of conflict that Congress had in mind. Subchapter L rules should apply in this case, and there is no loss reserve limitation rule under Subchapter L.

4. **The Treatment of Contingent Liabilities Reflected in the Proposed Loss Reserve Limitation Rule Cannot Validly Be Applied to Unpaid Loss Reserve Additions.**

We believe that the tax treatment of contingent liabilities should not under any circumstance be applied to post-transaction additions to an unpaid loss reserve. With a contingent liability, there is a sequence of events that occurs—in the same order every time. First, a purchaser assumes a contingent liability of a seller. Then some economic event occurs that causes the contingent liability to no longer be contingent, and the buyer capitalizes the amount of the liability incurred (it cannot deduct the expense of another) as additional basis in the asset purchased. At the same time, the seller has additional amount realized, and someone (generally the seller) obtains a deduction. LTR 91-25-001 (TAM). The tax significance of the contingent liability ends with the capitalization. The income, deduction, and basis adjustment are all in place, and nothing else happens in connection with the (previously) contingent liability.

We believe that a post-transaction addition to an unpaid loss reserve is so different from a contingent liability that such an addition simply cannot be squeezed into

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companies), the policyholders are also the owners of the corporation. If Subchapter C controlled Subchapter L in the case of conflicts between the two, it is not clear whether insurance (footnote continued)
the tax treatment of a contingent liability. First, a contingent liability has no tax significance until the occurrence of a future economic event. In contrast, a post-acquisition addition to an unpaid loss reserve, like the unpaid loss reserve itself, is based on the previous occurrence of an economic event, i.e., the occurrence of covered loss.

Second, it is the occurrence of the future economic event that causes a contingent liability to no longer be contingent. Since the post-acquisition addition to the reserve depended on the past occurrence of a covered loss, there is no future event that one could point to as being the event that removes the contingency, and nothing in the proposed regulations gives any indication of how or when the contingency would ever be removed. Third, in the case of a contingent liability, the buyer cannot deduct the expense associated with the liability because the expense is that of another taxpayer. In contrast, in the case of an actual or deemed assumption reinsurance transaction, the expense (policy claims) is the expense of the assuming company, i.e., new target in a section 338(h)(10) transaction. See, e.g., FSA 1998-476, supra. Therefore, the justification for requiring the buyer to capitalize the expense attributable to a contingent liability, i.e., that it is the expense of another taxpayer, does not exist in connection with additions to unpaid loss reserves. We believe that this difference, and the differences noted above, amply demonstrate that the tax treatment of a contingent liability simply cannot be applied to post-transaction additions to an unpaid loss reserve because such additions are not contingent to begin with.

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companies would be able to claim the statutorily provided deduction for dividends to their (footnote continued)
5. The Proposed Loss Reserve Limitation Rule Is Inconsistent with the Ordinary Operation of an Insurance Business. As discussed above, it seems clear that there is nothing contingent about the obligation of an assuming insurance company to policyholders whose contracts have been acquired in an assumption reinsurance transaction. Even if there were, as we have shown there would be no reason to disturb the assuming insurance company's deductions for increases to its loss reserves.

a. The Proposed Loss Reserve Limitation Rule Ignores Bona Fide Business Needs. Bona fide business considerations, rather than tax considerations, dominate consideration in the reserve setting process for most insurance companies. Insurance companies must justify the level of their reserves to rating agencies and state insurance departments. We believe that only in a truly rare situation might an insurance company acquire an inadequately reserved insurance company in order to obtain a tax deduction for subsequent reserve increases. In such cases, the Service can use other anti-abuse rules, such as section 269, among other provisions and principles, to deny any deductions perceived to be improper.

b. Increasing Reserves in Order to Obtain a Tax Deduction Would Result in a Net Economic Loss. Except in extraordinary circumstances, it seems readily apparent that increasing reserves merely to obtain a tax deduction would be a poor business practice. Assume for example that Target has assets
of $1,000,000, reserves (on both a tax and a statutory basis) of $800,000, and surplus of $200,000 as shown:

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<thead>
<tr>
<th>Amount</th>
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<tbody>
<tr>
<td>Assets</td>
<td>$1,000,000</td>
</tr>
<tr>
<td>Reserves</td>
<td>(800,000)</td>
</tr>
<tr>
<td>Surplus</td>
<td>$200,000</td>
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</tbody>
</table>

Assume also that Target's reserves could legitimately be stated at $850,000, but in that case it would have only $150,000 of surplus, as shown:

<table>
<thead>
<tr>
<th>Amount</th>
<th></th>
</tr>
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<tbody>
<tr>
<td>Assets</td>
<td>$1,000,000</td>
</tr>
<tr>
<td>Reserves</td>
<td>(850,000)</td>
</tr>
<tr>
<td>Surplus</td>
<td>$150,000</td>
</tr>
</tbody>
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Assume that Acquiring made a qualified stock purchase of the stock of Target, and an election was made under section 338(h)(10). If Target sought to increase its reserves in the amounts shown above (from $800,000 to $850,000), it would realize a tax benefit of $17,500 (i.e., 35% × $50,000), but that tax benefit would only partially mitigate the $50,000 pre-tax surplus drain. In the example, after accounting for the tax benefit, Target would have $167,500 of statutory surplus, as opposed to the $200,000 it had had prior to the reserve increase, a net surplus reduction of $32,500. It seems very unlikely, absent some extraordinary circumstances, that an acquired insurance company would want to reduce its surplus by $50,000 on a pre-tax basis in order to derive a tax benefit of $17,500.

A real example of this can be found in the pages of the Financial Times of London. In an article on July 30, 2002, the Financial Times of London reported that:
Standard & Poor's warned yesterday that it might cut Munich Re's triple-A credit ratings, after the world's largest reinsurer said it would inject a further Dollars 2bn into American Re, its troubled US subsidiary, and raised its estimate of losses from the September 11 attacks by another Dollars 500m.

The moves, coupled with indications that the reinsurer might not meet its 2002 profit forecast because of weak stock markets, sent Munich Re's shares sharply lower.

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Munich Re shares dropped 2.9 per cent to Euros 236 in Frankfurt.

Jane Croft and Tony Major, *Munich Re Hit by S&P Rating Threat*, THE FINANCIAL TIMES (LONDON), July 11, 2002, at 46 (copy attached). The partially mitigating effect of the tax benefit from additions to unpaid loss reserves does not mask the fact that an increase in unpaid loss reserves is an adverse financial event.

c. **The Proposed Loss Reserve Limitation Rule Fails to Accomplish Its Intended Purpose.** In any event, we believe that the proposed loss reserve limitation rule should be eliminated because, in many cases, it would fail to accomplish its intended purpose. Worse, however, we are concerned that it would discourage a major segment of the insurance industry from making elections under section 338(h)(10).\(^\text{12}\)

\(^{12}\) The very result that the proposed loss reserve limitation rule is designed to prevent might be obtainable outside of section 338(h)(10) in a consolidated return setting, in which many insurance companies are likely to find themselves. Assume that as a result of a qualified stock purchase Target becomes a member of the Acquiring consolidated group. Acquiring and Target can forgo a section 338(h)(10) election, and when Target increases its reserves immediately after the acquisition the benefit of the resulting deduction will flow to Acquiring via the consolidated return rules, although there might be a limitation under section 382 on the immediate use of the (footnote continued)
6. The Proposed Loss Reserve Limitation Rule Seems to Be an Anti-Abuse Rule. We believe that the rationale for the proposed loss reserve limitation rule, \textit{i.e.}, the need for capitalization, is based on a faulty premise, as shown above. An alternative rationale for the rule, \textit{i.e.}, the idea that one taxpayer might achieve a better tax result than another taxpayer from a given set of circumstances, does not seem to have been raised previously as a tax policy concern. In fact, such differing tax results seem to be a not uncommon occurrence. Ultimately, therefore, one must ask whether the proposed loss reserve limitation rule is actually an anti-abuse rule.\textsuperscript{13} If so, we believe that it is both overbroad and ineffective.

We believe that the wide scope and potential application of the proposed loss reserve limitation rule would be significantly overbroad as an anti-abuse rule. In fact, it would capture the transactions of potentially every insurance company involved in a section 338(h)(10) election that determines after a transaction that the unpaid loss reserve of the target must be increased for any reason other than to take into account the time value of money. We question whether such a broad application of the rule is truly intended or is truly necessary. On the other hand, we firmly believe that, if the proposed loss reserve limitation rule were retained in the final regulations, a significant segment of the insurance industry would be economically foreclosed from taking advantage of the deductions, even if Target cannot use them, itself. Thus, in that example, Acquiring might derive a greater tax benefit than Target could have derived from deductions attributable to Target's reserve additions, but the proposed regulations fail to address that result.

\textsuperscript{13} If the rule is not an anti-abuse rule, one must wonder why there is an exception for insurance companies that are in receivership.
election provided by section 338(h)(10). When one considers that the fundamental purpose of the regulation project that has led to the proposed regulations was to draft guidelines that would enable insurance companies to make elections under section 338(h)(10), such a result would be unfortunate, indeed.

Whether the proposed loss reserve limitation rule is intended as an anti-abuse rule or not, we believe that it is unnecessary and punitive, and that other measures are available to assuage the concerns of the Treasury and the Service. For example, in the case of an insurance company that joins in a section 338(h)(10) election, if an examining agent feels the parties have understated unpaid loss reserves as of the transaction date, he has the authority to propose an increase to those reserves. That, it seems, would accomplish both of the rationales asserted in the Preamble without unfairly subjecting other taxpayers to a harsh and punitive disallowance. Further, there are other existing anti-abuse provisions in the Code, particularly section 269, which are better suited to deal with these situations than an extremely ineffectual and overbroad rule such as the proposed loss reserve limitation rule.

Finally, it is worth noting that the proper computation and amount of reserves for tax purposes is an issue that is sometimes resolved only by litigation between insurance companies and the Service.\(^{14}\) We believe that the proposed loss reserve limitation rule unnecessarily creates a new potential context for controversy over the

appropriate level of reserves, and appropriate timing of increases in those reserves, for tax purposes. New target may decide in the course of its fifth taxable year that certain lines of its business are under-reserved, and therefore may increase reserves in that year. Because the tax effect of such an increase in the fifth year would be so different from the tax effect that would have occurred had new target increased its unpaid loss reserves in the previous year, examining agents would have a new incentive to challenge the adequacy of new target's unpaid loss reserves in the earlier year, seeking to apply the proposed loss reserve limitation rule.\textsuperscript{15}

\textbf{B. Applicable Asset Acquisitions.} The proposed regulations provide that the sale of the assets of a corporation constitutes the sale of a business and is subject to the rules under section 1060 if the sale includes assets to which "goodwill and going concern value can attach." Especially in an insurance context, we believe that it could be very difficult to determine when such a rule applies and when it does not. We understand that a transfer of workforce in connection with the transfer of an insurance business would constitute a transfer of an asset to which goodwill and going concern value can attach. Such an example seems obvious to us, and seems to give little guidance to insurance companies in most reinsurance transactions. If our understanding on this point is correct, we believe that it would be helpful to include references to them in the Preamble to the final regulations, including an example if possible. The current section

\textsuperscript{15} Moreover, the Service's resources for auditing transactions are finite, and it appears to us that a rule such as the proposed loss reserve limitation rule can only place a further strain on those resources.
1060 regulations include examples involving a manufacturing business, a retail store, and a car wash. These businesses hold different types of tangible assets than an insurance company, and accordingly, the application of the examples to an insurance company is somewhat limited. If you would like, we would be pleased to provide you some proposed examples.

We believe that the proposed regulations under 1060 should also be clarified in terms of the extent of the application of an assumption reinsurance approach to indemnity reinsurance transactions. The proposed regulations generally provide that the transfer of insurance or annuity contracts and the assumption of the related reserves that are deemed to occur by reason of an election under section 338(h)(10) should be accounted for generally under the provisions of subchapter L. The proposed regulations provide similar rules for acquisitions of insurance businesses that are governed by section 1060, whether effected through assumption or indemnity reinsurance.\(^\text{16}\) Prop. Treas. Reg. § 1.060-1(c)(5) states that where an insurance business is transferred, the rules of the Treas. Reg. § 1.1060 are modified by the principles of Prop. Reg. § 1.338-11(a) through (d). We understand that the purpose of that statement is to apply a residual method of determining purchase price and asset value, but as it is written, we are concerned that the reference to Prop. Treas. Reg. § 1.338-11(c) could be read as a requirement to treat all

\(^{16}\) In that regard, the proposed regulations under section 1060 appropriately state that the mere reinsurance of insurance contracts by an insurance company does not constitute an applicable asset acquisition, even if it enables the reinsurer to establish a relationship with the owners of the reinsured contracts.
applicable asset acquisitions, whether or not actually effected as assumption reinsurance transactions, as assumption reinsurance.

If an assuming company in an assumption reinsurance transaction acquires an intangible asset within the meaning of section 197, it must amortize that asset in accordance with the rules of section 197. If the transaction is an indemnity reinsurance transaction, however, section 197 does not apply, see section 848(g), and any amount otherwise attributable to an intangible asset under section 197 is currently deductible. Although the proposed regulations do not explicitly address this point, we understand that there was no intention to subject indemnity reinsurance to section 197. We recommend that the final regulations provide clarification on this point to eliminate any confusion.

C. **Section 846(e).** Insurance companies must discount their unpaid losses using a specified loss payment pattern and a specified interest rate. Generally, the applicable loss payment pattern is derived from the loss payment patterns for the industry as a whole. Section 846(e), however, provides an election for insurance companies to discount its unpaid losses using loss payment patterns based on their own experience. The only condition is that an insurance company must have "sufficient historical experience for the line of business to determine a loss payment pattern" in order to make the election. The regulations under section 846(e) provide that an insurance company must have five years of experience in any given line of business before it will be allowed to elect to use its own historical experience to discount its unpaid losses. The election can only be made in a determination year, which is every fifth year beginning in 1987.
The proposed regulations deny new target the opportunity to make the historical experience election under section 846(e) because, according to the Preamble, "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 . . . ." We do not understand the tax policy objective that such a denial would serve. The purpose of the historical experience requirement is so that the loss payment patterns used by insurance companies that made the historical experience election would be realistic. The loss payment patterns used by a company making the historical experience election are drawn from the annual statement that the company files with its insurance regulators. Consequently, the data is considered reliable. The conditions for making the historical experience election have been structured by reference to factors outside of the Code, i.e., the insurance company's annual statement. The fictional "new target" will have the same annual statements that the fictional "old target" had. We believe that it is inappropriate to extend the "separate company" fiction so far as to deny new target the ability to continue old target's historical experience election.

Moreover, we believe that the denial of new target's ability to continue an election made by old target under section 846(e) is inconsistent with other instances in which the Treasury and the Service have treated old target and new target as the same corporation under section 338, where tax policy favors treating old target and new target as the same corporation. For example, old target and new target are treated as the same corporation with respect to employee benefits plans and with respect to qualification for certain credits that are calculated based upon employee wages. In that context, the
regulations under section 338 recognize that new target's employees and benefit plans are the same as old target's employees and benefit plans, and it would be disruptive to other provisions of the Code, not to mention to the employees, to treat new target as an entirely new corporation. Treas. Reg. § 1.338-1(a)(2)(i). If the Treasury and the Service can alter the "new corporation" rule in those circumstances, we believe that Treasury and the Service should be able to alter the rule in this case because it would further an important tax policy -- the policy underlying section 846(e).

**D. Conclusion.** In our view, the Treasury and the Service generally fashioned a system under section 338(h)(10) that provides insurance companies with needed guidance in making elections under section 338. We believe, however, that the analytic underpinning of the proposed loss reserve limitation rule is weak, and that the rule is unnecessarily punitive. If it is, as might appear, intended to be an anti-abuse rule, then it should be so structured and limited to cases of abuse. We believe that the final regulations should clarify that treating an indemnity reinsurance transaction under the assumption reinsurance rules of Prop. Treas. Reg. § 1.338-11 is not intended to force an indemnity reinsurance transaction into capitalization under section 197 which clearly does not apply. Finally, we believe that denying new target the opportunity to continue old target's historical experience election exalts form over substance and, in view of other exceptions that have been made to the "new corporation" rule in similar contexts, fails to serve an important tax policy.