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DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR

FROM: Deborah A. Butler
Assistant Chief Counsel CC:DOM:FS

SUBJECT: Assumption Reinsurance and Section 338(h)(10) Election

This Field Service Advice responds to your memorandum dated September 17, 1999. Field Service Advice is not binding on Examination or Appeals and is not a final case determination. This document is not to be cited as precedent.

LEGEND

Parent =
Seller =
Old Targets =

New Targets =

Buyer =

Parent 2 =
Reinsurer =
Date 1 =
$c =
$d =

$e =
$f =
$g =
$h =
$j =
$k =
$m =
$n =
$p =
$q =
$r =
$s =
$t =
$u =
$v =
$w =
$x =
$y =
$z =

ISSUES

1. Whether the principles of Treas. Reg. § 1.817-4(d), relating to assumption reinsurance transactions, are applicable to the purchase Old Targets' life insurance company stock which is treated as a deemed asset sale as the result of an election under I.R.C. § 338(h)(10).[1]/

2. Assuming that the principles of Treas. Reg. § 1.817-4(d) are applicable to the section 338(h)(10) deemed asset sale, whether the intangible value of the insurance contracts purchased from Old Targets ("insurance in force") is treated as part of the consideration received by New Targets the deemed assumption reinsurance transaction and, if so, how this insurance in force is to be valued.

3. Whether Parent 2's error in reporting of assets at tax basis, rather than fair market value as required by Form 8023-A, renders the section 338(h)(10) election invalid.

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[1]/ Unless otherwise indicated, section references throughout are to the Internal Revenue Code of 1986, as amended and in effect during the taxable years at issue.

CONCLUSIONS

1. The section 338(h)(10) deemed asset sale of Old Targets' life insurance business should be characterized as a deemed assumption reinsurance transaction for Federal income tax purposes. Accordingly, the principles of Treas. Reg. § 1.817-4(d) apply to Old Targets and New Targets in determining the tax consequences of the portion of the section 338(h)(10) asset sale represented by the purchase of Old Targets' insurance contracts.

2. Under the principles of Treas. Reg. § 1.817-4(d), New Targets must include in premium income under I.R.C. § 803(a)(1) the intangible value of the insurance contracts purchased in the deemed assumption reinsurance transaction. Under the principles of Treas. Reg. § 1.817-4(d)(2)(iii), the value of the purchased insurance contracts is based on the difference between the current value of the assets transferred to New Targets (other than any value attributable to the purchased insurance contracts) and the increase in New Targets' reserves resulting from the transaction. Accordingly, we conclude that New Targets should not be required to recognize premium income under section 803(c)(1) based on the appraised value of Old Targets' insurance in force when this value exceeds the difference between the current value of net assets transferred to New Targets (other than any value attributable to the purchased insurance contracts) and the increase in New Targets' reserve liabilities resulting from the deemed reinsurance transaction.

3. Parent 2's error in valuing certain assets on the schedule attached to Form 8023-A at tax basis rather than fair market value does not invalidate the section 338(h)(10) election. Alternatively, even if the section 338(h)(10) election were not valid per se, Parent 2 has substantially complied with the requirements of section 338(h)(10) and, therefore, the election is valid. These conclusions are based solely on the limited facts presented and assume that the section 338(h)(10) election was not otherwise defective.

FACTS

Parent is the widely held and publicly traded parent of a consolidated group that includes Seller. Prior the transaction described below, Seller held all of the stock of Old Targets, which were engaged in the life insurance business.

Parent 2 is a life insurance company and the parent of Buyer. Buyer is a holding company formed for the purpose of enabling Parent 2 to acquire Old Targets. On Date 1, Buyer completed the purchase of all of the outstanding stock of Old Targets from Seller.

Concurrent with this transaction, Seller agreed to reinsure all of the existing single premium deferred annuity business of Old Targets through Reinsurer, a newly created subsidiary, for the balance of the contracts' current guarantee periods. The value of the reinsured annuity business was approximately $c. As the annuity contracts matured, Reinsurer was required to transfer cash in an amount equal to the then current account value (less a recapture fee) to Old Targets. To facilitate the transaction, Seller also agreed to provide additional financial assurances, in the form of a letter of credit for $d, payable jointly to Old Targets and Reinsurer, to support the reinsured annuity contracts.

Buyer and Seller made a section 338(h)(10) election to treat this stock acquisition as a qualified stock purchase ("QSP") of Old Targets' assets for tax purposes. Parent 2 executed and timely filed a Form 8023-A, reporting the Target companies' assets at their tax basis rather than their fair market value.

The amount paid by Buyer for all of the outstanding stock of Old Targets was approximately $e. At the time of the stock acquisition, the value of Old Targets' assets and liabilities was as follows:

Assets

Class I (cash and cash equivalents)	$f
Class II (bonds and other securities)	$g
Class III (other tangible assets)	$h
Total	$j

Liabilities

Total policy reserves (tax basis)	$k
Accrued expenses	$m
Other liabilities	$n
Total	$p

In addition, in accounting for the stock acquisition on its consolidated financial statements prepared under generally accepted accounting purposes ("GAAP"), Parent 2 recorded the following intangible assets with respect to New Targets:

Present value of future profits	$q
Goodwill	$r
Total	$s

In filing the returns of New Targets, Parent 2 accounted for the acquisition under the general rules of asset acquisitions under I.R.C. §§ 338 and 1060. Thus, no items of income or deductions were recorded as a result of the stock acquisition. Moreover, Parent 2 determined the tax basis of New Targets' assets in accordance with a residual basis allocation method. Under this method, the basis assigned to the New Targets' insurance in force was determined based on the amount of basis remaining after all other assets, i.e., assets in Category I, Category II, and Category III, had been allocated basis to the extent of their fair market values. This residual method of allocation resulted in a tax basis of $t being assigned to New Targets' insurance in force.

You have concluded that the deemed asset sale created by the section 338(h)(10) election should be treated as an assumption reinsurance transaction for tax purposes. Thus, the deemed reinsurance transaction results in income and deductions for Old Targets and News Targets under the provisions of I.R.C. §§ 803 and 805 in addition to Old Targets' gain or loss realized on the sale of their assets and the step-up in New Targets' basis in those same assets.

You have also concluded that, for purposes of determining the consideration received by New Targets in respect of the deemed assumption reinsurance transaction, it is appropriate to include the fair market values of all of the tangible and intangible assets transferred by Old Targets, including the appraised value of Old Targets' insurance in force and goodwill. Under this position, New Targets would be required to recognize premium income under section 803(a)(1) based on the difference between the fair market value of the total assets received over the cash paid for Old Targets' stock and the other liabilities assumed ($u - ($e for stock + $v payment for assumption of other liabilities) = $w).[2]/

Correspondingly, New Targets would be allowed a deduction under section 805(a)(2) for an increase in reserves based on the amount of the tax reserve liabilities assumed in the deemed assumption reinsurance transaction ($k). You have concluded that the excess of the value of the tangible and intangible consideration received by New Targets in the deemed assumption reinsurance

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[2]/ For purposes of this memorandum, we have determined New Targets' purported premium income in accordance with the valuation of New Targets' tangible and intangible assets in your request for advice . This results in an inclusion, net of the other liabilities assumed, of $w. Also in your request for advice, however, you assert that New Targets should report premium income, net of the other liabilities assumed, of $x. We have been unable to reconcile this difference.

transaction over the increase in New Targets' reserves resulting from the transaction is taxable as ordinary income for New Targets' first taxable year. See Treas. Reg. § 1.817-4(d)(3), Example 4.

LAW AND ANALYSIS

Characterization of the Section 338(h)(10) Asset Sale As An Assumption Reinsurance Transaction (Issue 1)

At issue in this case is the interplay between the provisions of Subchapter C and Subchapter L of the Internal Revenue Code of 1986 when a group of life insurance companies are acquired in a stock purchase that is treated as a deemed sale of assets pursuant to an election under section 338(h)(10). More specifically, you have asked whether it is appropriate for the Service to apply Subchapter L rules to a section 33h(h)(10) deemed sale or whether the taxpayer instead should be permitted to rely on the general treatment of asset acquisitions under sections 338 and 1060.

Life insurance companies are subject to the federal tax provisions generally applicable to all corporations, including those found in Subchapter C. Life insurance companies are also subject to the provisions of Subchapter L. 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. This rule of preeminence developed in direct response to Congressional intent expressed in the legislative history of Subchapter L.[3]/

In developing the rule of preeminence, the courts have consistently held that the provisions of Subchapter L must be narrowly applied because those provisions afford insurance companies significant benefits not available to taxpayers generally. Thus, the tax treatment of a given item turns on a close examination of whether a provision in Subchapter L specifically addresses it, as a Subchapter L provision will supersede a Subchapter C provision only if there is a direct conflict between the two. See, e.g., UNUM Corp. v. United States, 130 F.2d 501 (1st Cir. 1997), aff'g 929 F.Supp. 15 (D.Me. 1996), cert. denied, 119 S. Ct. 42 (1998) (Subchapter C controlled the tax treatment of payments made to policyholders in a demutualization); see also, Colonial American Life Insurance Company, 491 U.S. 244 (1989).

In general, the sale of stock of any corporation, including an insurance company, is an exchange taxable under I.R.C. § 1001. The selling shareholder will

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[3] See S. Rep. No. 291, 86th Cong., 1st Sess. 39 (1959), 1959-2 C.B. 770, 798).

recognize gain or loss on the transaction, but there is generally no tax at the corporate level. The purchaser will take the stock with a cost basis.

Section 338 allows certain purchasers of stock to treat the purchases as purchases of assets. A purchasing corporation may elect to treat a stock acquisition as an asset acquisition if it acquires 80% of the voting power and 80% of the total value of the stock of a target corporation (not taking into account certain preferred stock) by purchase within a 12-month period. If a purchasing corporation makes a section 338(g) election, the target is treated as if it (as the old target) had sold all of its assets at the close of the acquisition date at fair market value in a single transaction.

The acquired corporation (as the new target) is then treated as a new corporation that purchased all of the assets at the beginning of the day after the acquisition date. Thus, the new target's basis in the purchased assets is equal to their "deemed purchase price" reflecting the purchasing corporation's grossed-up basis in the stock of the target company, properly adjusted for target company liabilities (including tax liabilities on the deemed asset sale) and other relevant items. The old target's gain or loss from the deemed asset sale is included in the old target's final return. However, if the old target is a member of a selling consolidated group, that final return is consolidated with neither the selling corporation's nor the purchasing corporation's consolidated group. A section 338(g) election generally does not change the tax treatment of the selling shareholders, i.e., they are still taxed on their stock sale, notwithstanding the purchasing corporation's section 338(g) election.

In some cases, the selling shareholders may join with the purchasing corporation in making a section 338(h)(10) election, which changes the tax treatment of old target and the selling shareholders. If an election is made under section 338(h)(10), the stock sale will be treated as a sale of the assets held by the acquired corporation. The old target, as a member of the selling group, is deemed to sell all its assets for an amount equal to the modified aggregate deemed sale price ("MADSP").[4]/ The sale proceeds are deemed distributed to the seller in a complete liquidation and, thus, the old target's attributes will generally transfer to the seller. The seller recognizes no gain or loss on the sale of the target stock to the purchaser.

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[4]/ MADSP is equal to the grossed up basis in the purchaser's recently purchased target stock, plus the new target's liabilities that were old target's liabilities, plus other relevant items. MADSP is allocated under rules of Treas. Reg. § 1.338(b)-2T and gain or loss is recognized by the old target on the deemed sale of each of its assets. See Treas. Reg. § 1.338(h)(10)-1(e)(1).

The new target is deemed to purchase all of its assets from the old target for an amount equal to the adjusted grossed up basis ("AGUB").[5]. The new target is generally considered a new corporation unrelated to the old target for purposes of Subtitle A.

In light of this model of a deemed asset sale created by section 338(h)(10), we agree that the portion of the deemed sale represented by purchase of Old Targets' existing insurance policies should be treated as an assumption reinsurance transaction for Federal income tax purposes. The operation of section 338(h)(10) requires that New Targets be treated, for tax purposes, as new corporations that acquired all of Old Targets' assets and assumed all of Old Targets' liabilities, including the liabilities on Old Targets' existing insurance contracts, in a taxable transaction.

There is considerable authority for our conclusion that the deemed sale represented by purchase of Old Targets' existing insurance policies should be treated as an assumption reinsurance transaction for Federal income tax purposes. First, if an insurance company were to acquire the existing business of another insurance company in a taxable transaction outside of section 338, the portion of this transaction represented by the transfer of the selling company's insurance contract liabilities would be accomplished using assumption reinsurance. See Kentucky Central Life Insurance Company v. Commissioner, 57 T.C. 482 (1972); Union Bankers Insurance Co. v. Commissioner, 64 T.C. 807 (1975); Security Benefit Life Insurance Company v. United States, 726 F.2d 1491 (10th Cir. 1984); see also Security Industrial Insurance Company v. United States, 702 F.2d 1234, 1237 (5th Cir. 1983) (assumption reinsurance is the life insurance industry's functional equivalent of a direct asset acquisition).

Second, when the entire insurance business of a target life insurance company was acquired in a stock purchase/liquidation qualifying under former

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[5]/ AGUB is equal to the grossed up basis in the purchaser's recently purchased target stock, plus the purchaser's basis in its nonrecently purchased stock (adjusted to reflect the mandatory gain recognition election under Treas. Reg. § 1.338(b)-1(e)(2) and (3)), plus the new target's liabilities that were the old target's liabilities, and other relevant items. AGUB is adjusted in later years to take into account adjustment events, such as a contingent liability becoming fixed and determinable. AGUB is allocated among the "purchased assets" under the provisions of Treas. Reg. § 1.338(b)-2T.

I.R.C. § 334(b)(2), the statutory predecessor of section 338,[6]/ the portion of the transaction represented by the transfer of the distributor corporation's existing insurance contracts to the acquiring corporation was treated as an assumption reinsurance transaction. See Southwestern Life Insurance Company v. United States, 75-1 USTC ¶ 9321 (N.D. Tex. 1975), aff'd, 560 F.2d 627 (5th Cir. 1977), cert. denied, 435 U.S. 995 (1978) (sale of insurance company stock treated as an asset sale under former section 334(b)(2) taxed as an assumption reinsurance transaction; no distinction between a direct acquisition of a block of insurance contracts and the acquisition of the company holding the block of insurance contracts).

Third, Congress expressed its view regarding the application of the assumption reinsurance rules to a deemed purchase of insurance contracts occurring by reason of a section 338 election during its deliberations relating to the enactment of section 197. Section 197 provides an amortization deduction for certain intangible property, including the purchase price of insurance contracts acquired by means of an assumption reinsurance transaction (to the extent that such value exceeds the amounts otherwise capitalized under I.R.C. § 848 with respect to the transaction). See I.R.C. § 197(f)(5).

The legislative committee reports underlying section 197 state that the principles of Treas. Reg. § 1.817-4(d) apply for purposes of determining the amortizable basis of insurance contracts acquired by means of an assumption reinsurance transaction, including any acquisition of an insurance contract occurring by reason of an election under section 338. See H. Rep. No. 11, 103 D CONG., 1ST SESS.. 760, 775 FN. 150 (1993), 1993-3 C. B. 167, 351; H.R. Conf. Rep. No. 213, 103D Cong., 1st Sess. 675, 687 fn. 25 (1993), 1993-3 C.B. 393, 565.

An argument can be made that this legislative history is evidence of Congressional intent to establish a rule solely for section 197 purposes. However, that would be an anomalous result with no apparent policy reason. A stronger argument can be made that the legislative history reflects Congress' understanding of the effect of a section 338 election by an insurance company.

Finally, as a policy matter, the purpose and operation of Subchapter L support the application of Subchapter L to a section 338(h)(10) election. Subchapter L is, in essence, a method of tax accounting enacted to achieve a proper matching of income and expense items. Life insurance companies typically

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[6]/ The principal difference between former section 334(b)(2) and current section 338 is the liquidation requirement. Section 338 was intended to remove that requirement, not to change the characterization of the transaction as an asset sale.

receive premium income upfront and throughout the life of a life insurance contract, but do not pay claims until much later in the life of the contract. This mismatching of income and expense items distorts an insurance company's economic income. Subchapter L attempts to neutralize this distortion by allowing life insurance companies to accelerate deductions for the payment of claims, and thereby defer reporting income, through the use of policy reserves. The intended result is a more realistic measurement of true income. But, the provisions of Subchapter L are intended only to affect the timing of the reporting (and, in some respects, the character) of items related to insurance contracts. Thus, the mechanics of Subchapter L were crafted to ensure that, over the life of the contracts, all income and expense items related to the contracts are taken into account.

Not all contracts are held to term by a life insurance company. An insurer may decide to discontinue a line of business or to terminate its entire insurance business before the contracts are completed. In that case, an insurer ("the ceding company") will typically transfer all of its rights and responsibilities under the contracts to another insurer ("the reinsurer") in a transaction known as assumption reinsurance.

Under an assumption reinsurance agreement, the ceding company is completely relieved of its liability under the contracts. The ceding company has, at that point, ceded its risk under the contracts. To ensure that all items related to the contracts are properly accounted for as items relating to the insurance contracts, Subchapter L requires that the assumption reinsurance payments are matched, in timing and character, with all other items related to the contracts. More specifically, this is accomplished as set forth in Treas. Reg. § 1.817-4(d), which provides that:

> [assumption reinsurance] shall not be treated as the sale or exchange of a capital asset but shall be subject to the provisions of sections 806(a) and 809 [former provisions re: changes in reserves, and gain and loss from operations] and the regulations thereunder. However, if in connection with a transaction described in the preceding sentence the reinsured or reinsurer transfers an asset which is a capital asset within the meaning of section 1221 (as modified by section 817(a)(2)), such transfer shall be treated as the sale or exchange of a capital asset by the transferor.

By requiring the ceding company to treat the proceeds of the assumption reinsurance transaction as the final income and expense items of the reinsured contracts, the regulation ensures that a ceding company properly offsets prior deferral and acceleration when it concludes its insurance operations. Conversely,

the regulation makes clear that this event, which marks the beginning of the reinsurer's need for the special accounting rules provided by Subchapter L, is subject to the provisions of Subchapter L for the determination of the tax treatment on the reinsurer's side also. This treatment of assumption reinsurance has been affirmed by the courts and Congress, even as it repealed a portion of the regulation in enacting sections 848 and 197(f)(5).[7]/

Although section 338 provides for the tax treatment of a deemed asset sale resulting from a section 338(h)(10) election, the resulting transaction is the cessation of the old target (the ceding company) and concurrent transfer or assumption of the old target's insurance contracts by the new target (the reinsuring company). This is not only an appropriate time for the old target's "true-up," it is in fact the only time for the old target's true-up, as the old target's existence ceases in the transaction. Similarly, it is appropriate for the new target to take the amounts received as consideration for reinsuring the contracts into account as premium income, as this consideration is the first item it will receive on these contracts. Indeed, unless the new target treats the reinsurance premium as income, it would be inappropriate to allow the new target the deduction for establishing reserves with respect to those contracts. This is precisely the situation at which the Subchapter L provisions are directed.

Moreover, if Subchapter L were not applied to a section 338(h)(10) transaction, the Subchapter L requirement that a ceding company true up when it cedes the risk would be rendered a mere election. Because insurance companies are able to defer income during the life of the contracts using Subchapter L, an accounting for the deferral must be made upon exiting the business, or there is a permanent distortion of timing and character of income that undermines the purpose and the integrity of the Subchapter L method.

In summary, the purpose of section 338(h)(10) is to recharacterize, for Federal tax purposes, a sale of stock as a sale of assets. The legal authorities as well as the policy considerations support giving effect to that characterization for purposes of taxing it as assumption reinsurance. Furthermore, the broad language

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[7]/ See H.R. Rep. No. 101-964, 101st Cong., 2d Sess., 1069, fn. 9 (enactment of section 848, repealing capitalization rule of Treas. Reg. § 1.871-4(d) while affirming the overall operation of the regulation); H.R. Rep. No. 103-111, fn. 151, at 775, H. R. Rep. No. 103-213, fn. 26, at 687 (enacting section 197(f)(5): "the amount paid or incurred by the acquirer/reinsurer under an assumption reinsurance transaction is to be determined under the principles of present law. (See Treas. Reg. § 1.817-4(d)(2))"; see also Kentucky Central Life Insurance Company v. Commissioner, supra, Mutual Savings Life Insurance Co., v. U.S., 488 F.2nd 1142 (5th Cir. 1974).

of Treas. Reg. § 1.338-2(d) suggests that there is no bar to treating the new target as though it has actually purchased the assets of the old target for such purpose. Accordingly, we conclude that the deemed sale of a life insurance company's assets occurring by reason of a section 338(h)(10) election is properly treated as an asset sale. To the extent it is a transaction specifically addressed by a regulation under Subchapter L, Treas. Reg. § 1.817-4(d), it is governed by such provision.

Issue 2 -- Determination of Purchase Price of Old Targets' Insurance in Force under Treas. Reg. § 1.817-4(d)

The tax consequences of assumption reinsurance transactions involving life insurance companies are clear and well-established and are set forth with specificity in Treas. Reg. § 1.817-4(d). Under Treas. Reg. § 1.817-4(d), the reinsurance of all or part of a life insurance company's contracts by another company in a transaction in which the assuming company becomes directly liable to the policyholders is not treated as the sale or exchange of a capital asset, but instead is a transaction giving rise to ordinary income under section 803. However, if either party transfers a capital asset in connection with the reinsurance transaction, this transfer is treated as the sale or exchange of the asset by the transfer. In addition, Treas. Reg. § 1.817-4(d) provides that an assumption reinsurance transaction produces the following consequences under Subchapter L for the parties to the transaction:

(1) The ceding company recognizes ordinary income under section 803(a)(2) resulting from a decrease of its previously deducted tax reserves on the assumption of liability on the reinsured contracts by the reinsurer.

(2) The ceding company treats the payment or transfer of assets to the reinsurer as consideration for the assumption of liability on the reinsured contracts as an item of deduction under section 805(a)(6). However, any amount received by the ceding company from the reinsurer is applied against, and reduces, its deduction under section 805(a)(6), and any excess over this deduction is an item of ordinary income under section 803(a)(2).

(3) The reinsurer includes the payment or consideration received from the ceding company for the assumption of liability on the reinsured contracts as an item of premium income under section 803(a)(1). See I.R.C. § 803(b)(1)(E).

(4) The reinsurer includes the reserves on the reinsured contracts in its year-end reserves, thus recognizing an item of deduction based on a increase in reserves under section 805(a)(2).

(5) The reinsurer treats a payment to the ceding company for the reinsured contracts, to the extent the amount meets the requirements of I.R.C. § 162, as a deferred expense which is recognized as a deduction under section 805(a)(8) over the reasonably estimated life of the reinsured policies.

(6) If the reinsurer receives from the ceding company a net amount which is less than the increase in the reinsurer's reserves resulting from the transaction, the reinsurer is treated (i) as having received from the ceding company an amount equal in total to its increase in reserves, and (ii) as having paid to the ceding company for the purchase of the contracts an amount equal to the excess of the increase in reserves over the net amount actually received from the ceding company. See Treas. Reg. §§ 1.817-4(d)(2)(iii) and 1.817-4(d)(3), Examples 1-3.

The provisions of Treas. Reg. § 1.817-4(d)(2)(iii) and the revised examples in Treas. Reg. § 1.817-4(d)(3), which require a reinsurer to include an additional amount of premium income based on the intangible value of the purchased insurance contracts to the extent that the increase in the reinsurer's reserves resulting from the transaction exceeds the consideration received from the ceding company, were added in 1976 to correct a disparity in the tax treatment of a reinsurer under the examples in prior Treas. Reg. § 1.817-4(d)(3), depending on whether the ceding company had made a gross asset transfer and the reinsurer had made a separate bonus payment or whether the parties had structured the transaction to provide for a net asset transfer from the ceding company.

Although the intangible value of the insurance contracts was the same under both transactions, the examples in prior Treas. Reg. § 1.817-4(d)(3) suggested that the reinsurer would be required to amortize the bonus payment in a gross asset transfer, but would recognize a net deduction when this bonus had been subtracted from the assets by the ceding company in a netting transaction. The purpose of the modification to the regulations was "to make it clear that merely because money

passes solely from the seller to the purchaser in a netting transaction, does not mean that the purchaser has paid nothing for the insurance contract." 40 Fed Reg 34128 (1975), cited in Ernst & Young, 1 Federal Income Taxation of Life Insurance Companies, § 14.08[4] (1998).

In essence, Treas. Reg. § 1.817-4(d)(2)(iii) and the revised examples in Treas. Reg. § 1.817-4(d)(3) treat the excess of the policy reserve liabilities assumed by the reinsurer over the tangible assets received from the ceding company as if two exchanges had taken place: (i) in one exchange the reinsurer receives as consideration (and thus income) for assuming the reserve liability an amount equal to that liability, and (ii) in the second exchange, the assuming company pays the ceding company an amount reflecting the intangible value of the contracts purchased by the assuming company. See Beneficial Life Insurance Co. v. Commissioner, 79 T.C. 627, 639 (1982).

Despite repeated challenges, the courts have generally upheld the validity of the modified regulation, noting that Treas. Reg. § 1.817-4(d)(2)(iii) is consistent with established tax law relating to the assumption or payment of liabilities with appreciated property. See Oxford Life Insurance Company v. United States, 790 F.2d 1370 (9th Cir. 1986); Beneficial Life; Kentucky Central Life Insurance Co. v. Commissioner, 57 T.C. 482 (1972); but see Security Benefit Life Insurance Co. v. United States, 726 F.2d 1491 (10th Cir. 1984) (subject transaction did not involve offsetting obligations); Mutual Savings Life Insurance Co. v. United States, 488 F.2d 1142 (5th Cir. 1974) (taxpayer entitled to rely on examples in prior Treas. Reg. § 1.817-4(d)(3)).

In effect, the manner in which the intangible value of the purchased insurance contracts is determined under Treas. Reg. § 1.817-4(d)(2)(iii) reflects basic tax principles regarding the treatment of sales or exchange transactions. Under general principles of tax law, the value of properties exchanged in an arm's length transaction is presumed to be equal. This includes the situation in which property is transferred in satisfaction of an obligation. United States v. Davis, 370 U.S. 65, 72 (1962); Kentucky Central, 57 T.C. at 496.

Moreover, where a taxpayer acquires all the assets of another in a taxable transaction, the amount of the liability assumed is treated as part of the consideration paid for acquiring the tangible and intangible assets received. Commissioner v. Tufts, 461 U.S. 300, 306, 313 (1983); Crane v. Commissioner, 331 U.S. 1, 14 (1947). Thus, the courts have generally viewed the characterization

of the reinsurer as receiving tangible and intangible consideration equal to the reserve liabilities assumed as a proper result under the tax law.

Based on the above, we agree with your proposed position that, in applying the principles of Treas. Reg. § 1.817-4(d) to a section 338(h)(10) deemed sale of Old Targets' insurance business, it is appropriate to treat New Targets as receiving consideration (and thus, income under section 803(a)(1)) based on the intangible value of the insurance contracts purchased from Old Targets.

We disagree, however, as to the manner in which the consideration paid for Old Targets' insurance contracts has been determined in this case. Under your proposed position, New Targets are treated as receiving insurance in force and other intangible property with a total fair market value of $s as part of the consideration received from Old Targets in the deemed assumption of Old Targets' insurance contract liabilities. The valuation of these intangible assets is determined based on the value assigned to these assets on the GAAP financial statements.

We conclude that your position regarding the valuation of Old Targets' insurance in force is contrary to the manner in which the value of the purchased insurance contracts is determined under Treas. Reg. § 1.817-4(d)(2)(iii). Under that regulation, the reinsurer is treated (i) as receiving consideration from the ceding company equal to the net increase in the reinsurer's reserves resulting from the transaction, and (ii) as having paid the ceding company for the purchase of the insurance contracts an amount equal to the excess of the amount of consideration actually received from the ceding company (other than any value attributable to the purchased insurance contracts) over the net increase in the reinsurer's reserves resulting from the transaction. Therefore, under the principles of Treas. Reg. § 1.817-4(d)(2)(iii), the intangible value of the insurance contracts purchased in an assumption reinsurance transaction is determined based on the difference between the payment received from the ceding company, other than any value attributable to the reinsured policies, and the increase in the reinsurer's reserves resulting from the transaction.

The mechanical measurement of insurance in force under this regulation may be compared to the residual method of valuation for section 197 assets in the nature of goodwill and going concern value for section 338 deemed asset sales generally, except that insurance in force and goodwill/going concern value are commingled in respect of assumption reinsurance transactions. <u>See</u> Treas. Reg. § 1.338(b)-2T.

Based on Treas. Reg. § 1.817-4(d)(2)(iii), we believe that New Targets should determine the amount paid for Old Targets' insurance in force in the present case as follows:

Reserve liabilities assumed (tax basis)	$k
Less: tangible assets received (net of amount paid for target stock and other liabilities assumed	($y)
Purchase price of insurance contracts	$t

Accordingly, for purposes of determining the tax consequences of the deemed assumption reinsurance transaction, the amount of premiums and other consideration under section 803(c)(1) treated as received by New Targets in respect of the assumption of Old Targets' insurance contracts is limited to the reserve liabilities assumed.

In this case, the fair market value of the assets deemed transferred to New Targets, other than any value attributable to the purchased insurance contracts, is less than the increase in New Targets' reserves resulting from the deemed assumption reinsurance transaction. Therefore, we conclude that Treas Reg. §§ 1.817-4(d)(2)(iii) and 1.817-4(d)(3), Examples 1-3, are applicable to the deemed assumption reinsurance transaction for purposes of determining the amount paid for Old Targets' insurance in force and, corresponding, the amount of additional consideration deemed received by New Targets, and included in premium income under section 803(a)(1), for the assumption of liability on Old Targets' insurance contracts.

Validity of Section 338(h)(10) Election (Issue 3)

Section 338(h)(10)(A) provides the Secretary with authority for prescribing regulations to make a section 338(h)(10) election. Section 338(h)(10)(C) provides similar authority with respect to the collection of information pursuant to such an election, "at such times and in such manner as may be provided in regulations." Treas. Reg. § 1.338(h)(10)-1(d)(2) states in pertinent part that, "a section 338(h)(10) election is made...on Form 8023-A in accordance with the instructions to the form..."

Page 2 of the Form 8023-A states, "if a section 338(h)(10) joint election is made for the target corporation, listed in schedule B, attach a schedule as appropriate listing the amount of a) the consideration paid for the target stock in the QSP, b) the liabilities of the target corporation on the acquisition date... In addition, describe any other relevant items and list the aggregate fair market value by class of the Class II and III assets of the target corporation on the acquisition date. Also identify each intangible amortizable Class III asset, specifying its fair market value and useful life."

Parent 2 timely filed the form required by the instructions but listed the Class II, III, and intangible amortizable Class III assets at their tax basis rather than their fair market value. The tax effect of Parent 2's misrepresentation is approximately $z. For the following reasons, we conclude that Parent's 2's error does not affect the validity of the section 338(h)(10) election.

We first address whether Parent 2's election is valid without regard to the doctrine of substantial compliance, which is employed where the election has fallen short in some minor respect. Neither section 338(h)(10(A), regarding the requirements for making the election, nor section 338(h)(10)(C), regarding the furnishing of certain information, is explicitly dependent on the other. Therefore, it does not necessarily follow that the furnishing of the information is a prerequisite to a valid election. Moreover, section 338(h)(10)(C) contemplates that the information may be provided at some time other than at the time of the election. Section 338(h)(10)(C) states "at such times and in such manner as may be provided in the regulations, furnish to the Secretary the following information." As long as Parent 2 otherwise complied with the requirements of making an election under section 338(h)(10), the reporting error should not affect the validity of the election. Support for this conclusion is also found on Form 8023-A.[8]/

Treas. Reg. § 1.338(h)(10)-1(d)(2) states that the election is to be made on Form 8023-A in accordance with the instructions thereto. Both Congressional delegations, the requirements for the election in 338(h)(10)(A) and for the furnishing of information in section 338(h)(10)(C), are referenced in the instructions to Form 8023-A. The instructions do not explicitly state that validity of the election is conditioned on the submission of the financial information and in fact indicate otherwise. The instructions state that <u>if an election is made</u> (emphasis added), the taxpayer should attach a schedule as appropriate listing the various information. Moreover, the language used in the instructions, requiring the financial information, does not imply that its inclusion is necessary for a valid election. It begins by

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[8]/ The requirement for a section 338(h)(10) election do not appear in the regulations but on the form and the instructions thereto.

stating, "attach a schedule as appropriate listing...In addition, describe any other relevant items...Also, identify..." These phrases do not give the impression of necessity or importance. For these reasons, we conclude that Parent 2's section 338(h)(10) election is not invalidated by the errors contained in the schedule attached to Form 8023-A.

Alternatively, even if Parent 2's failure to follow the instructions to form 8023-A were to invalidate the election, Parent 2 may be able to demonstrate substantial compliance with the regulatory requirements of a section 338(h)(10) election. Courts apply the doctrine of substantial compliance where taxpayers fail to properly adhere to the requirements of making an election. The critical question is whether the requirements for making an election relate to the substance or essence of the statute. If so, strict adherence to all of the statutory and regulatory requirements is a precondition to an effective election. American Air Filter Co. v. Commissioner, 81 T.C. 709, 719 (1983). If, on the other hand, the regulatory requirements are procedural and the essential statutory purposes have been met, then substantial compliance will suffice. For the reasons stated above it is evident that the information to be included in the schedule and attached to Form 8023-A is procedural and that Parent 2 substantially complied with the procedural requirement. Knight-Ridder Newspapers Inc. v. U.S., 743 F.2d 781 (1984) (holding that where Congress intends an election to be binding, a regulatory notice requirement is essential). Similarly, the binding nature of a section 338(h)(10) election makes the requirement of notice essential.

Another factor to be considered in determining whether a taxpayer has substantially complied with regulatory requirements is the severity of the sanction in relation to the violation. Columbia Iron & Metal Co. v. Commissioner, 61 T.C. 5, 12 (1973) ("To deny the deduction merely because the petitioner failed to prove the proof of the acts at the time required by the respondent would establish a sanction which is out of proportion to the shortcoming and not warranted or justified under the circumstances.") Parent 2 appear to have otherwise complied fully with the requirement for a section 338(h)(10) election. To invalidate Parent 2's election, under the facts presented in this case, would be out of proportion to the error in valuation made on the attached schedule to Form 8023-A.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

First, although we view the transaction in the instant case as subject solely to the provisions of Subchapter L, we do not mean to imply that such an approach will be applied in all cases involving the sale of a life insurance company's stock subject to a section 338(h)(10) election. Treas. Reg. § 1.817-4(d) does not imply that a transaction is treated as one indivisible whole in which all the assets transferred to the purchaser are considered payment for the assumption of the

ceding company's insurance liabilities. If a corporation holds both insurance and noninsurance business, an exclusive application of the regulation would subject the entire transaction to Subchapter L (i.e., ordinary income) treatment. Such a result is inappropriate to the extent the transaction is not an insurance transaction.

The better reading of Treas. Reg. § 1.817-4(d) is that, like Subchapter L, the regulation generally applies to a transaction only to the extent the transaction is specifically one which the provision is intended to cover, viz., assumption reinsurance. Thus, in the case of a transaction that includes both insurance and noninsurance elements, e.g., the sale of a corporation with a significant noninsurance business, the analysis must take that into account and bifurcate the transaction into insurance and noninsurance components, applying Subchapter L only to the insurance component.

If, on further examination, it appears there is a significant noninsurance component of the transaction that is not governed by Subchapter L, further advice should be requested.

Second, we recognize that our conclusion regarding Issue 2 differs from the views that we expressed in connection with prior Field Service Advice issued in another case. In that case, we indicated that the new target would be treated under the provisions of Treas. Reg. § 1.817-4(d) as receiving premiums and other consideration for the assumption of the liability on the old target's insurance policies equal to the fair market value of the assets transferred by the old target. We also noted that the examples illustrating the rules in Treas. Reg.§ 1.817-4(d) do not limit the premiums and other consideration reportable by the reinsurer in respect of the assumption of another company's insurance policies to the amount of reserve liabilities assumed. See Treas. Reg. § 1.817-4(d)(3), Example 4.

In that case, however, there was no indication that the disparity between the fair market value of the assets transferred to the new target over the reserve liabilities assumed was attributable to the valuation of the target's insurance in force. That is, we based our conclusion relating to the application of the principles of Treas. Reg. § 1.817-4(d) to the section 338(h)(10) deemed asset sale on the assumption that the value of the target's Category I, Category II, and Category III assets, other than any value attributable to the purchased insurance contracts, exceeded the sum of the amount paid for target stock plus the amount of target's insurance reserves and other liabilities assumed by the buyer.

Finally, we note that in your request for advice you refer to a purported dividend of one of Old Targets' subsidiaries. We do not see how this transaction would affect the issues discussed herein. However, we recommend that you

develop the transaction factually and request further Field Service Advice as appropriate.

Please call if you have any further questions.

Deborah A. Butler
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By: ______________________________
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