on prototypes or parts of prototypes that are sold as scrap, or waste, or for recycling, where the duty owed is based upon value, the relevant value is the market value of the prototypes or parts, based upon their character and condition following use for the purposes prescribed in HTSUS subheading 9817.85.01. The market value will generally be measured by the selling price. Should a prototype or part of a prototype become a component of another product that is sold as scrap, waste, or recycled material, the relevant market value would be that portion of the selling price attributable to the component (prototype or part) as provided in this paragraph.

(f) *Articles admitted under TIB.*—(1) *Duty-free entry available.* Under the procedure presented in paragraph (f)(2) of this section, an entry of an article made under a temporary importation bond (TIB) solely for testing, experimental or review purposes under HTSUS subheading 9813.00.30 may be converted into a duty-free entry under HTSUS subheading 9817.85.01, if the following conditions exist:

(i) The article meets the definition for ''prototypes'' in paragraph (b) of this section (U.S. Note 6(a) to Subchapter XVII, Chapter 98, HTSUS); and

(ii) The TIB entry for the article was in effect and had not been closed, and the TIB period for the article had not expired, as of November 9, 2000.

(2) *Procedure for converting TIB entry to duty-free entry.*—(i) *Importer request.* The importer must submit a written request, or an electronic equivalent as authorized by Customs, that a TIB entry made under HTSUS subheading 9813.00.30, which was in effect and had not been closed, and for which the TIB period had not expired, as of November 9, 2000, be converted instead into a duty-free consumption entry under HTSUS subheading 9817.85.01.

(ii) *Action by Customs.* Customs will convert the TIB entry under HTSUS subheading 9813.00.30 to a duty-free entry under HTSUS subheading 9817.85.01, provided that the port director is satisfied that the conditions set forth in paragraphs (f)(1)(i) and (f)(1)(ii) of this section have been met. When the TIB entry is converted, the bond will be cancelled and the entry closed. Once the conversion is complete, the port director will provide a courtesy acknowledgment to this effect to the importer in writing or electronically.

Robert C. Bonner,

Acting Commissioner of Customs.

Approved: March 5, 2002.

Timothy E. Skud,

Acting Deputy Assistant Secretary of the Treasury.

[FR Doc. 02–5557 Filed 3–7–02; 8:45 am]

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DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

[REG–118861–00]

RIN 1545–AY49

Application of Section 338 to Insurance Companies

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking and notice of public hearing.

SUMMARY: This document contains proposed regulations that apply to a deemed sale or acquisition of an insurance company's assets pursuant to an election under section 338 of the Internal Revenue Code, to a sale or acquisition of an insurance trade or business subject to section 1060, and to the acquisition of insurance contracts through assumption reinsurance. It also contains proposed regulations under section 381 concerning the effect of certain corporate liquidations and reorganizations on certain tax attributes of insurance companies. The proposed regulations apply to insurance companies and to corporations selling and purchasing stock of insurance companies. This document also provides a notice of public hearing on the proposed regulations.

DATES: Written or electronic comments and requests to speak (with outlines of oral comments to be discussed) at the public hearing scheduled for September 18, 2002, must be received by August 28, 2002.

ADDRESSES: Send submissions to: CC:ITA:RU (REG–118861–00), room 5226, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand delivered Monday through Friday between the hours of 8 a.m. and 5 p.m. to CC:ITA:RU (REG–118861–00), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW., Washington, DC 20044. Alternatively, taxpayers may submit comments electronically directly to the IRS Internet site at www.irs.gov/regs. The public hearing will be held in the auditorium, Internal Revenue Building, 1111 Constitution Avenue, NW., Washington, DC.

FOR FURTHER INFORMATION CONTACT: Concerning the proposed regulations, Gary Geisler, (202) 622–3970, or Mark Weiss, (202) 622–7790, concerning submissions of comments, the hearing, and/or to be placed on the building access list to attend the hearing, Guy Traynor, (202) 622–7180 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Background

Overview of the Proposed Regulations

These proposed regulations apply to taxable asset acquisitions and dispositions of insurance businesses and companies, many of which occur by virtue of elections under section 338 of the Internal Revenue Code (Code). A number of questions have arisen concerning the tax consequences of such transactions, and numerous requests for clarification were received in response to the proposal of regulations under sections 338 and 1060 (REG–107069–97, 1999–2 C.B. 346, 64 FR 43462) in 1999. The Treasury decision finalizing those regulations in February, 2001, announced the intention of the IRS and Treasury to provide guidance regarding the treatment of a deemed asset sale by an insurance company in a separate project (TD 8940, 2001–15 I.R.B. 1016, 1017, 66 FR 9925). That additional guidance is proposed in this document.

In taxable asset acquisitions governed by section 338 or 1060 generally, the total cost of the acquisition is apportioned among specific assets under a residual method that extrapolates the price of each asset from the overall price of the transaction (including assumed liabilities), ranking the assets in classes for priority of allocation, with goodwill and going concern value (Class VII assets) ranked last and section 197 intangibles (Class VI assets) ranked next to last. *See* §§ 1.338–6(b)(2) and 1.1060–1(a)(1). Rights under an insurance company's outstanding insurance contracts (commonly known as insurance in force) that are acquired through assumption reinsurance as part of a taxable asset acquisition generally are intangible assets that constitute section 197 intangibles within the meaning of section 197(d) and, hence, are classified as Class VI assets under § 1.338–6(b)(2)(vi).

The term *assumption reinsurance* refers to an arrangement whereby the reinsurer, or buyer, becomes solely liable to the policyholders on contracts transferred by the ceding company, or seller, who ceases to have any liability under the transferred contracts. *See* § 1.809–5(a)(7)(ii); see also *Colonial American Life Ins. Co.* v. *Commissioner*, 491 U.S. 244, 247 (1989); *Beneficial Life Ins. Co.* v. *Commissioner*, 79 T.C. 627, 636 (1982). It has historically been the IRS's position that, where insurance contracts are acquired from an insurance company as part of a taxable asset acquisition, the transfer of contract rights and assumption of related liabilities is treated as an assumption reinsurance transaction if the ceding company ceases to be liable to the policyholders. *See Southwestern Life Ins. Co.* v. *Commissioner*, 560 F.2d 627 (5th Cir. 1977), *cert. denied,* 435 U.S. 995 (1978); *see also* H.R. Rep. No. 103–213, 103d Cong., 1st Sess. 687 n.25 (1993); § 1.338–1(a)(2).

Section 1.817–4(d) prescribes rules for the income tax treatment of assumption reinsurance transactions entered into by life insurance companies in the ordinary course of business. Under § 1.817–4(d)(2)(ii) and (iii), the reinsurer is treated as receiving premium income from the reinsured in an amount equal to at least the increase in the reinsurer's reserves resulting from the transaction, and the reinsurer is entitled to deduct the increase in its reserves that is attributable to the acquisition of the insurance contracts. If the reinsurer receives an amount less than the amount of such reserves, the difference is treated as the amount paid by the reinsurer for the purchase of the reinsured contracts (*i.e.*, the ceding commission). The reinsurer must capitalize the ceding commission as an item of deferred expense. Thus, the reinsurer's deduction for its increase in reserves resulting from the assumption reinsurance transaction offsets premium income, and the reinsurer is treated as purchasing intangible assets (i.e., insurance contracts) to the extent that the net consideration received by the reinsurer is less than its increase in reserves. If the actual amount received by the reinsurer exceeds the increase in the reinsurer's reserves resulting from the transaction, the entire amount received by the reinsured is treated as premium income, and the reinsurer is not treated as having paid any amount for the purchase of the reinsured contracts (*i.e.*, the economics of the transaction indicate that the insurance contracts have no positive value).

Under § 1.817–4(d), the ceding company treats the gross amount paid to the reinsurer, reduced by any payment received from the reinsurer, as an item of deduction for consideration paid for reinsurance. *See* § 1.817–4(d)(2)(i). This deduction fully or partially offsets the amount included in the gross income of the ceding company that is attributable to the decrease in the ceding company's reserves as a result of the reinsurance transaction. Because the amount of the deduction is reduced by the amount that the reinsurer actually or implicitly pays to purchase the contracts, the net effect is to treat any amount received by the ceding company for the sale of the reinsured contracts as ordinary income.

Although § 1.817–4(d) applies only to assumption reinsurance transactions involving life insurance companies, the general structure of the regulations is not based on any statutory provisions unique to life insurance companies. Moreover, because these rules are an application of general principles of insurance taxation, many should apply not only to assumption reinsurance transactions, but also to indemnity reinsurance transactions, where the ceding company is not fully relieved of the policy risks.

The proposed regulations generally treat the transfer of an insurance or annuity contract or group of such contracts (hereinafter insurance contracts) and the assumption of related reserve liabilities that are deemed to occur by reason of an election under section 338 in a manner consistent with the treatment of ordinary assumption reinsurance transactions under § 1.817–4(d) and other provisions of subchapter L of chapter 1, subtitle A of the Code and the regulations promulgated thereunder. The proposed regulations provide similar rules for acquisitions of insurance businesses governed by section 1060, whether effected through assumption or indemnity reinsurance. Thus, in the case of both a deemed and an actual transfer of an insurance business, the reinsurer (in the case of a section 338 election, new target) is treated as receiving premium income for its assumption of reserve liabilities and having an offsetting deduction for its increase in reserves, and the ceding company (in the case of a section 338 election, old target) is treated as having income in the amount of the reduction in its reserves and having a deduction for the premium it pays for the reinsurer's assumption of those liabilities. Moreover, consistent with § 1.817–4(d), the consideration allocated to the value of the insurance contracts acquired in the assumption reinsurance transaction is treated as an amount paid by the reinsurer to purchase intangible assets and as ordinary income to the ceding company.

However, section 1.817–4(d) does not fully describe the income tax treatment of insurance contracts that are transferred and the related reserve liabilities that are assumed as part of the acquisition of an entire company or trade or business. In particular, § 1.817–4(d) addresses transactions in which the consideration paid for the transfer of insurance contracts and assumption of related liabilities is known and not part of a larger acquisitive transaction. Therefore, in order to give effect to the principles and rules governing taxable asset acquisitions for all trades or businesses generally, these proposed regulations depart in certain respects from the rules governing assumption reinsurance transactions effected in the ordinary course of business. The key elements of the proposed regulations are as follows:

1. In general, the seller's tax reserves are treated in the same manner as fixed liabilities that have been taken into account for Federal income tax purposes and, thus, the seller's closing tax reserves are treated as a liability in the computation of the seller's aggregate deemed sales price (ADSP) and the buyer's adjusted grossed-up basis (AGUB).
2. The residual method that otherwise applies to transactions governed by sections 338 and 1060 applies to allocate the ADSP and AGUB among classes of transferred assets, including insurance contracts, which constitute Class VI assets (regardless of whether they are section 197 intangibles). Thus, the amount of consideration allocated to insurance contracts under the residual method is treated as the amount paid by the buyer for the purchase of insurance contracts in the assumption reinsurance transaction (i.e., as a ceding commission to the seller).
3. The gross amount of the reinsurance premium paid by the seller to the buyer is deemed to equal the seller's closing tax reserves in all cases, thereby eliminating the possibility of immediate net taxable income to the buyer.

Computation and Allocation of AGUB and ADSP

In accordance with the principles set forth above, these proposed regulations provide rules regarding the computation and allocation of AGUB and ADSP where the target is an insurance company. *See* proposed § 1.338–11(a) through (c). A special rule provides that, for purposes of allocating AGUB and ADSP under the residual method, the fair market value of insurance contracts is the amount a willing reinsurer would pay a willing ceding company in an arm's length transaction as a ceding commission for the reinsurance of the specific insurance contracts if the gross reinsurance premium for the insurance contracts were equal to old target's tax reserves for the insurance contracts. *See* proposed § 1.338–11(b)(2).

Rules comparable to the proposed rules governing the computation and allocation of AGUB and ADSP are proposed to apply to applicable asset acquisitions under section 1060. See proposed § 1.1060–1(c)(5). To insure that these rules apply only to acquisitions of insurance businesses and not to ordinary reinsurance transactions, the proposed regulations describe when an acquisition of insurance contracts will be treated as an applicable asset acquisition. The proposed regulations provide that the mere reinsurance of insurance contracts by an insurance company is not an applicable asset acquisition, even if it enables the reinsurer to establish a customer relationship with the owners of the reinsured contracts. However, the transfer of an insurance business is an applicable asset acquisition if the purchaser acquires significant business assets, in addition to insurance contracts, to which goodwill and going concern value could attach. See proposed § 1.1060–1(b)(9).

Treatment of Liabilities

For purposes of computing ADSP and AGUB, the proposed regulations treat old target's closing tax reserves (before giving effect to the deemed sale and assumption reinsurance transaction) as a liability. See proposed § 1.338–11(b)(1). 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. *See Pacific Transport Co.* v. *Commissioner*, 483 F.2d 209, 214 (9th Cir. 1973), *cert. denied,* 415 U.S. 948 (1974); *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.

For a number of reasons, however, the IRS and Treasury believe that it would be inappropriate to require capitalization of all such post-acquisition increases in an insurance company's assumed reserve liabilities. First, to the extent that reserves are discounted and post-acquisition increases are attributable to increases in the present value of assumed liabilities reflected in the acquisition date reserves, such increases are more properly treated as a currently deductible business expense of the reinsurer, analogous to interest on a fixed liability, rather than as a capital cost of the acquired assets. Second, to the extent that insurance reserves represent estimates of contingent liabilities under insurance contracts, the IRS and Treasury recognize that adjustments to these estimates are customary and that, unlike adjustments in other businesses, such adjustments may either increase or decrease an insurance company's taxable income. Thus, it would be impractical and inappropriate to treat all such adjustments as adjustments to the cost of acquired assets. No inference, however, is intended regarding the tax treatment of contingent liabilities in situations not covered by these proposed regulations.

Although the IRS and Treasury believe that certain increases in reserves that are attributable to acquired insurance contracts should be currently deductible, the IRS and Treasury believe that post-acquisition reserve increases should be capitalized in certain situations where it becomes clear that the ceding company's tax reserves as of the acquisition date were understated. In such cases, increasing the tax reserves attributable to the acquired insurance contracts after the acquisition should not produce a more favorable result for the reinsurer than had the ceding company increased such reserves before the acquisition. Accordingly, proposed § 1.338–11(d) provides for the capitalization by the reinsurer of certain reserve increases in the four taxable years after the acquisition date.

Tax reserve increases from three sources with respect to acquired contracts could potentially be subject to capitalization under these 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. See proposed § 1.338–11(d)(3) and (d)(4). In particular, the proposed regulations require capitalization of unpaid loss reserve increases in excess of cumulative annual increases of two percent from the acquisition date reserves for unpaid losses attributable to acquired insurance contracts and for acquired contracts transferred through reinsurance transactions. Capitalization is not required, however, to the extent increases to reserves for unpaid losses attributable to acquired insurance contracts reflect the time value of money. In addition, the reinsurer is not required to capitalize any post-acquisition reserve increases to the extent such increases occur while it is under state receivership or to the extent the deduction for the reserve increase is spread over the 10 succeeding taxable years pursuant to section 807(f). *See* proposed § 1.338–11(d)(2).

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. *See* proposed § 1.338–11(d)(1). The ceding company does not make any adjustments under this provision. *See* proposed § 1.338–11(d)(1).

Other Issues

In addition to providing guidance regarding the treatment of the deemed asset sale under section 338 and the assumption reinsurance transaction that is deemed to occur in connection therewith, the proposed regulations provide guidance on several other issues that arise in the context of these transactions. In general, these other rules also apply to insurance companies that sell an insurance business in a transaction governed by section 1060 if the sale occurs in connection with the complete liquidation of the ceding company. *See* proposed § 1.1060–1(c)(5). The rules in the proposed regulations under section 197 also apply to reinsurers of insurance businesses in transactions governed by section 1060 if effected through assumption reinsurance.

Amortization Under Section 197

These regulations propose amendments to the regulations under section 197 to provide guidance concerning the treatment under section 197 of insurance contracts acquired through assumption reinsurance transactions. For purposes of this section, the term *insurance contracts* includes an annuity contract or group of annuity contracts. *See* proposed § 1.197–2(g)(5).

Section 197(f)(5) provides that, in the case of any amortizable section 197 intangible resulting from an assumption reinsurance transaction, the amount taken into account as the adjusted basis of such intangible under section 197 is the excess of (A) the amount paid or incurred by the acquirer in the assumption reinsurance transaction, over (B) the amount required to be capitalized under section 848 in connection with the transaction. For policy related intangibles acquired in an assumption reinsurance transaction, section 197(f)(5) determines the amount that must be capitalized and amortized under section 197 and the portion that may be expensed because it is reflected in the reinsurer's capitalization of specified policy acquisition expenses under section 848.

The current regulations under section 197 reserve the interpretation of section 197(f)(5) in the context of stock acquisitions with respect to which an election under section 338 is made. *See* § 1.197–2(g)(5)(ii)(C). For other assumption reinsurance transactions, § 1.197–2(g)(5)(ii)(A) interprets the amount paid or incurred as the amount determined under § 1.817–4(d)(2) and the amount required to be capitalized under section 848 as the amount of the specified policy acquisition expenses that are attributable to the reinsurer's net positive consideration for the reinsurance agreement (as determined under § 1.848–2(f)(3)).

The proposed regulations clarify that section 197(f)(5) determines the basis of an amortizable section 197 intangible asset with respect to insurance contracts acquired in an assumption reinsurance transaction. *See* proposed § 1.197–2(g)(5)(i)(A). Under these proposed regulations, the amount paid or incurred to acquire the relevant insurance contracts is, in a transaction governed by section 338 or 1060, the amount of the AGUB or consideration allocable to the insurance contracts under the residual method. For this purpose, the insurance contracts are valued by assuming a gross premium equal to the tax reserves. For transactions not governed by section 338 or 1060, the amount paid or incurred for insurance contracts is the excess of the increase in the reinsurer's tax reserves resulting from the transaction (computed in accordance with sections 807, 832(b)(4)(B), and 846) over the value of the net assets received from the ceding company in the transaction. *See* proposed § 1.197–2(g)(5)(i)(C).

Proposed § 1.197–2(g)(5)(i)(D) provides guidance concerning the amount required to be capitalized under section 848 in connection with an assumption reinsurance transaction. Section 848 requires an insurance company to capitalize annually an amount of its "general deductions" as "specified policy acquisition expenses" (DAC). Each year, an insurance company capitalizes its general deductions (amounts otherwise deductible under sections 161 *et seq.* and 401 *et seq.*) up to the percentage set forth in section 848(c) of the amount by which premiums received on specified insurance contracts in the taxable year exceeds return premiums and premiums paid for reinsurance (net premiums). The assumption reinsurance transaction itself typically generates no general deductions for the reinsurer. Accordingly, the amount to be capitalized must be determined by reference to the reinsurer's other general expenses and the effect of the transaction on the reinsurer's net premiums. The IRS and Treasury believe that, for purposes of section 197(f)(5)(B), the amount required to be capitalized under section 848 in connection with the transaction should take into account the ceding company's actual DAC capitalization amount, based on its general deductions for the year and its net premiums for the year, including premiums received in the assumption reinsurance transaction.

Under the proposed regulations, the computation of the amount described in section 197(f)(5)(B) is based on the actual capitalization amount and is determined at the end of the year by multiplying the DAC for the taxable year by a fraction, the numerator of which is the tentative positive capitalization amount for the relevant group of acquired insurance contracts and the denominator of which is the total tentative positive capitalization amount for the taxable year with regard to all specified insurance contracts. The tentative positive capitalization amount for the acquired insurance contracts is the net positive consideration received for the insurance contracts in the assumption reinsurance transaction multiplied by the percentage factor applicable to the insurance contracts under section 848(c). The total tentative positive capitalization amount for the taxable year is the sum of each year's net premiums (in each category) multiplied by its applicable percentage factor. The total amount required to be capitalized under section 197(f)(5)(B) cannot be less than zero or greater than the amount of the DAC for the year.

The amortization of intangibles under section 197 is a general deduction relevant in computing DAC. The amount of amortization, however, cannot be calculated until section 197(f)(5) is applied to compute the year's DAC. To avoid complex calculations, the proposed regulations assume that, for purposes of calculating the basis for amortization, one-half of the consideration allocated to the insurance contracts is amortizable under section 197. Comments are requested regarding alternative approaches to calculating the basis for DAC and section 197 amortization.

Losses on Dispositions of Acquired Insurance Contracts

In general, gain or loss is recognized on a disposition, including a retirement, of an asset. Section 197(f)(1)(A), however, overrides this general rule and bars the recognition of any loss on the disposition of an amortizable section 197 intangible acquired in a transaction if the taxpayer retains one or more other amortizable section 197 intangibles acquired in the same transaction. Where such a loss is denied, the adjusted bases of the retained intangibles are increased to account for the amount of the unrecognized loss. Section 1.197–2(g)(2)(B) provides that the abandonment of an amortizable section 197 intangible, or any other event rendering an amortizable section 197 intangible worthless, is treated as a disposition for purposes of the loss disallowance rule of section 197(f)(1)(A).

The regulations under section 197, however, do not provide any special guidance on the ability of a taxpayer to recover basis or the proper method for computing loss on the disposition of an amortizable section 197 intangible relating to insurance contracts. Such guidance is necessary because, in contrast to dispositions of other intangibles, subchapter L generally does not compute an "amount realized" on the disposition of insurance contracts. Accordingly, the proposed regulations provide such guidance.

Under the proposed regulations, a disposition of a section 197(f)(5) intangible is any event as a result of which, absent section 197, recovery of basis is otherwise allowed for Federal income tax purposes. *See* proposed § 1.197–2(g)(5)(ii)(A). The proposed regulations provide specific guidance regarding when recovery of basis is allowed with respect to a section 197(f)(5) intangible in the context of an indemnity reinsurance transaction. In particular, they provide that basis recovery is permitted when sufficient economic rights related to the insurance contracts that gave rise to such intangible have been transferred. Sufficient economic rights are treated as transferred when the ceding company transfers the right to future income on insurance contracts. Sufficient economic rights, however, are not treated as transferred if an experience refund provision, a recapture option, or another mechanism enables the taxpayer to retain a right to a substantial portion of the future profits on the reinsured policies. In addition, sufficient economic rights are not treated as transferred if the reinsurer assumes only a limited portion of the ceding company's risk relating to the underlying reinsured contracts (*e.g.,* excess loss reinsurance).

The proposed regulations also provide rules governing the amount of loss recognized on the disposition of a section 197(f)(5) intangible. Such loss equals the amount, if any, by which the adjusted basis of the section 197(f)(5) intangible immediately prior to the disposition exceeds the amount, if any, that the taxpayer receives from another person for the right to future income on the insurance contracts to which the section 197(f)(5) intangible relates. *See* proposed § 1.197–2(g)(5)(ii)(A)(2). The proposed regulations also provide that, in determining the amount of the taxpayer's loss on the disposition of a section 197(f)(5) intangible through a reinsurance transaction, any effect of the transaction on the amounts capitalized by the taxpayer as DAC is disregarded. *See* proposed § 1.197–2(g)(5)(ii)(B).

Other than in the case of certain reinsurance transactions, the proposed regulations do not provide specific guidance regarding when a disposition of a section 197(f)(5) intangible occurs or the extent to which a taxpayer should be permitted to recover the adjusted basis of a section 197(f)(5) intangible. Comments are requested regarding whether additional guidance should address other situations or issues.

Capitalization Under Section 848

DAC amounts are intended to serve as a proxy for an insurance company's actual cost of acquiring insurance contracts. An insurance company's DAC for a particular year will be negative (negative DAC) if return premiums and premiums paid for reinsurance for the year exceed premiums received in that year. Insurance companies are permitted to use any negative DAC to deduct currently the unamortized balance of DAC capitalized in prior years. Any remaining negative DAC can be carried forward to offset the DAC attributable to premiums received in future years.

Under proposed § 1.338–11(e), the assumption reinsurance transaction that results from section 338 generally has the same effect under section 848 as other assumption reinsurance transactions. That is, the assumption reinsurance transaction first reduces the current year's capitalization requirement and then offsets any unamortized DAC capitalized in prior years, which results in a current expense deduction.

The IRS and Treasury believe that, generally, once the ceding company no longer conducts an insurance business and ceases to exist for Federal income tax purposes, any relief from capitalization it might have enjoyed going forward is not appropriately transferred to a taxpayer other than a successor insurance company under section 381. Because regulations under § 1.381(c)(22)–1(b) have not been previously amended to reflect the enactment of section 848, the proposed regulations provide that remaining balances of DAC or excess negative DAC carry over to a successor insurance company in a section 381 transaction. *See* proposed § 1.381(c)(22)–1(b)(13). In all other cases, these proposed regulations provide that if, after giving effect to the reinsurance transaction in the deemed asset sale, the ceding company has remaining DAC or excess negative DAC, that remaining DAC is expensed or excess negative DAC is eliminated. *See* proposed § 1.338–11(e)(2).

Policyholders Surplus Account

Under section 815, as originally enacted by the Life Insurance Company Tax Act of 1959, stock life insurance companies were required to maintain a policyholders surplus account (PSA). Amounts contributed to a PSA were not included in income subject to tax under section 801. This deferral was based on the theory that such amounts may be necessary to meet future policyholders' claims.

The deferral afforded by section 815 generally terminated when there was a distribution from the PSA. For this purpose, a distribution included a distribution in partial or complete liquidation, a distribution in redemption of stock, dividend distributions other than distributions made by a corporation of its stock or rights to acquire its stock, payments attributable to distributions to shareholders made out of other accounts, payments in discharge of indebtedness attributable to distributions to shareholders made out of other accounts, and the balance of policyholders' surplus accounts on termination of life insurance status. *See* section 815, as originally enacted by the Life Insurance Company Tax Act of 1959; § 1.815–2(c); see also H.R. Conf. Rep. No. 34, 86th Cong., 1st Sess. 736 (1959), *Technical Explanation of the Life Insurance Company Income Tax Act of 1959,* at 762–64. However, a distribution did not include a carryover of the PSA to an acquiring corporation in a transaction described in section 381. Section 1.381(c)(22)–1(b)(7)(i); Rev. Rul. 77–248, 1977–2 C.B. 228. Therefore, distributions to a parent life insurance company of its subsidiary life insurance company's assets in the complete liquidation of the subsidiary under section 332 were not treated as distributions of the PSA subject to tax under section 801. *See* Rev. Rul. 77–248.

In 1984, Congress revised section 815 to prohibit further PSA contributions and to provide that any direct or indirect distribution to shareholders from the PSA would be subject to tax under section 801 in the year of the distribution. The legislative history indicates that the term *indirect distribution* is to be interpreted broadly to include both actual and constructive distributions of amounts in the PSA that directly or indirectly are used for the benefit of shareholders. See Staff of the Joint Committee on Taxation, 98th Cong., 2d Sess., *General Explanation of the Revenue Provisions of the Tax Reform Act of 1984,* at 594 (1984).

When a section 338(h)(10) election is made, old target is deemed to sell its assets for the ADSP and to distribute an amount equal to the proceeds of the stock sale, if any, to its shareholders in a deemed liquidation of old target. Section 332 generally applies to the receipt of this amount by the shareholder of an insurance company target. Although section 381 and the regulations thereunder provide that the PSA carries over to the acquiring corporation, the IRS and Treasury believe that where the acquiring corporation acquires less than 50 percent of old target's insurance business, such a rule is appropriate only to the extent that old target's insurance business is distributed in the section 381 transaction. To the extent that old target's insurance business is not distributed in a section 381 transaction, such amount is properly treated as a distribution of old target's PSA under section 815. When old target's PSA is separated from old target's insurance business, the purposes of the PSA are not served by further deferral because the old target's PSA is no longer necessary to meet future policyholders' claims. The separation of old target's

PSA from old target's insurance business effects a distribution of those funds, even if the shareholder receiving the distribution has an insurance business of its own. *See* proposed amendments to § 1.381(c)(22)–1(b)(7) and § 1.338–11(f); see also Rev. Rul. 95–19 (1995–1 C.B. 143).

Recently, some courts have divided over whether the deemed asset sale resulting from a section 338(g) election gives rise to a distribution by old target of the PSA to its shareholders. Compare *Bankers Life and Casualty Co.* v. *United States,* 79 AFTR2d (RIA) 1726 (N.D. Ill. 1996), *aff'd on other grounds,* 142 F.3d 973 (7th Cir. 1998), *cert. denied,* 525 U.S. 961 (1998), with *GE Life and Annuity Co.* v. *United States,* 127 F. Supp.2d 794 (E.D. Va. 2000). In a transaction with respect to which an election has been made under section 338(g), old target's shareholders are treated as having sold their stock of old target. In addition, old target is deemed to have sold its assets to new target for their fair market value and to terminate its existence. Because there has been a separation of the value attributable to the PSA and old target's life insurance business for which it was maintained, and the shareholders receive that value in a transaction other than a section 381 transaction, the proposed regulation effectively provides that the deemed asset sale pursuant to a section 338(g) election effects a distribution of the PSA to old target's shareholders to the extent the grossed-up amount realized for the recently purchased stock exceeds the shareholders surplus account. *See* proposed § 1.338–11(f).

Section 847 Estimated Tax Payments

To the extent that old target is deemed to transfer its insurance business to new target as a result of the deemed asset sale, old target's special loss discount account under section 847(3) must be reduced to the extent attributable to such transferred insurance business and old target must include the amount of such reduction in gross income for the taxable year of the transaction. *See* proposed § 1.338–11(g).

However, if any of old target's insurance business is distributed to its shareholders in a section 381 transaction, the acquiring corporation succeeds to the portion of old target's special loss discount account that is attributable to the insurance business that is transferred to the acquiring corporation. *See* proposed § 1.381(c)(22)–1(b)(14). This rule is intended to apply to both life and non-life insurance companies. Old target may apply the balance of its special estimated tax account as a credit against any tax resulting from the inclusion of this income. Because old target ceases to exist for Federal income tax purposes, any special estimated tax payments remaining after the credit are voided.

Section 846(e) Election

Under section 846(e), an insurance company may elect to compute discounted unpaid losses for all eligible lines of business using its historical payment pattern as shown on the most recent annual statement filed before the accident year instead of the historical payment pattern determined by the Commissioner. The election can only be made in a determination year, as defined by section 846(d), for the year in which the election is made and the four succeeding accident years.

Because new target is generally treated as a new corporation that may adopt its own accounting methods without regard to the methods used by old target (§ 1.338–1(b)), new target is not permitted to apply old target's experience as a result of any section 846(e) election made by old target under section 846. Thus, the proposed regulations do not provide any special rules under section 846.

Proposed Effective Dates

In general, these amendments are proposed to be applicable when filed as final regulations with the **Federal Register**.

Special Analyses

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It is hereby certified that these regulations do not have a significant economic impact on a substantial number of small entities. This certification is based on the fact that these regulations do not have a substantial economic impact because they merely provide guidance about the operation of the tax law in the context of acquisitions of insurance companies and businesses. Moreover, they are expected to apply predominantly to transactions involving larger businesses. Therefore, a Regulatory Flexibility Analysis under the Regulatory Flexibility Act (5 U.S.C. chapter 6) is not required. Pursuant to section 7805(f) of the Code, this notice of proposed rulemaking will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Comments and Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any written comments (preferably a signed original and eight (8) copies) and comments sent via the Internet that are submitted (in the manner described under the **ADDRESSES** portion of this preamble) timely to the IRS. The Department of the Treasury and the IRS specifically request comments on the clarity of the proposed regulations and how they may be made easier to understand. All comments will be available for public inspection and copying.

A public hearing has been scheduled for September 18, 2002, beginning at 10 a.m. in the auditorium, Internal Revenue Building, 1111 Constitution Avenue, NW., Washington, DC. All visitors must present photo identification to enter the building. Because of access restrictions, visitors will not be admitted beyond the immediate entrance area more than 15 minutes before the hearing starts. For information about having your name placed on the building access list to attend the hearing, see the **FOR FURTHER INFORMATION CONTACT** portion of this preamble.

The rules of 26 CFR 601.601(a)(3) apply to the hearing.

Persons who wish to present oral comments at the hearing must submit written or electronic comments and an outline of the topics to be discussed and the time to be devoted to each topic (preferably a signed original and eight (8) copies) by August 28, 2002.

A period of 10 minutes will be allotted to each person for making comments. An agenda showing the scheduling of the speakers will be prepared after the deadline for receiving outlines has passed. Copies of the agenda will be available free of charge at the hearing.

Drafting Information

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

List of Subjects in 26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

Proposed Amendments to the Regulations

Accordingly, 26 CFR part 1 is proposed to be amended as follows:

PART 1—INCOME TAXES

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

Authority: 26 U.S.C. 7805.

Section 1.338–11 is also issued under 26 U.S.C. 338. * * *

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

§ 1.197–0 Table of contents.

This section lists the headings that appear in § 1.197–2.

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

* * * * *

(g) * * *
(5) Treatment of certain insurance contracts.
(i) Determination of adjusted basis of amortizable section 197 intangibles with respect to insurance contracts under section 197(f)(5).
(A) In general.
(B) Assumption reinsurance transactions.
(C) Amount paid or incurred by the reinsurer for the insurance contracts.
(D) Amount required to be capitalized under section 848 in connection with the transaction.
(*1*) In general.
(*2*) Cross references and special rules.
(E) Example.
(ii) Application of loss disallowance rule upon a disposition of an insurance contract acquired in an assumption reinsurance transaction.
(A) Disposition.
(*1*) In general.
(*2*) Treatment of indemnity reinsurance transactions.
(B) Loss.
(C) Examples.
(iii) Effective Date.

* * * * *

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

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

* * * * *

(g) * * *

(5) *Treatment of certain insurance contracts*—(i) *Determination of adjusted basis of amortizable section 197 intangibles with respect to insurance contracts under section 197(f)(5)*—(A) *In general*. Section 197 generally applies to insurance contracts acquired from another person through an assumption reinsurance transaction. Section 197(f)(5) determines the basis of an amortizable section 197 intangible with respect to insurance contracts acquired in an assumption reinsurance transaction. The basis of such an intangible is the excess of the amount paid or incurred by the acquirer (reinsurer) for the relevant insurance contract or group of insurance contracts (hereinafter insurance contracts) over the amount, if any, required to be capitalized under section 848 in connection with such transaction. For purposes of this paragraph (g)(5), the term *insurance contracts* includes an annuity contract or group of annuity contracts.

(B) *Assumption reinsurance transactions*. An assumption reinsurance transaction means an arrangement whereby the reinsurer becomes solely liable to the policyholders on insurance contracts transferred by the ceding company. Thus, the transfer of insurance contracts and assumption of related liabilities deemed to occur by reason of a section 338 election for a target insurance company is treated as an assumption reinsurance transaction.

(C) *Amount paid or incurred by the reinsurer for the insurance contracts*. The amount paid or incurred to acquire insurance contracts is—

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

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

(*3*) In any other transaction, the excess of the increase in the reinsurer's tax reserves resulting from the transaction (computed in accordance with sections 807, 832(b)(4)(B), and 846) over the value of the net assets received from the ceding company in the transaction.

(D) *Amount required to be capitalized under section 848 in connection with the transaction*—(1) *In general*. With respect to specified insurance contracts (as defined in section 848(e)) acquired in an assumption reinsurance transaction, the amount required to be capitalized under section 848 in connection with the acquisition of the relevant contracts is determined by multiplying the reinsurer's specified policy acquisition expenses for that taxable year by a fraction, the numerator of which is the reinsurer's tentative positive capitalization amount for the relevant acquired insurance contracts and the denominator of which is the reinsurer's total tentative positive capitalization amount for the taxable year with regard to all specified insurance contracts. For purposes of this paragraph, the tentative positive capitalization amount for the relevant acquired insurance contracts is determined by multiplying the net positive consideration received by the reinsurer in the assumption reinsurance transaction for the insurance contracts by the percentage factor applicable to the insurance contracts under section 848(c). The reinsurer's total tentative positive capitalization amount for the taxable year is the sum of—

(*i*) 1.75 percent of the net premiums for the taxable year on annuity contracts;

(*ii*) 2.05 percent of the net premiums for the taxable year on group life insurance contracts; and

(*iii*) 7.7 percent of the net premiums for the taxable year on specified insurance contracts other than annuity or group life insurance contracts.

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

(*i*) Specified policy acquisition expenses cannot be less than zero;

(*ii*) Net premiums for the taxable year cannot be less than the sum of the positive consideration for all contracts acquired by the reinsurer in assumption reinsurance transactions during the applicable taxable year;

(*iii*) In computing general deductions (as defined in section 848(c)(2)), one-half of the amount paid or incurred by the reinsurer in the assumption reinsurance transaction is treated as a section 197 intangible for which an amortization deduction is allowed under section 197(a); and

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

(E) *Example*. The following example illustrates this paragraph (g)(5)(i):

Example. (i) Facts. On January 15, P purchases all the stock of T, an insurance company, in a qualified stock purchase and makes a section 338 election for T. T is the issuer of a group life insurance contract. Under §§ 1.338–6 and 1.338–11(b)(2), the amount of AGUB allocable to the group contract is $15. P and new T are calendar year taxpayers. New T's net premiums for the taxable year are $10,000, which includes $500 net consideration with respect to the group contract transferred in the transaction. The remaining $9,500 of new T's net premiums are on life insurance contracts that are not group contracts. New T's specified policy acquisition expenses for the taxable year, excluding the amortization of any section 197 intangible acquired in this *transaction, are $199.50.* (ii) *Analysis.* The deemed asset sale resulting from the election under section 338 is an assumption reinsurance transaction because new T becomes solely liable to policyholders on contracts for which old T formerly was liable. New T's adjusted basis in the group life insurance contract immediately following the assumption reinsurance transaction is determined as follows. The amount paid or incurred by new T in the assumption reinsurance transaction with respect to the contract is $15. Solely for purposes of computing the basis of new T's amortizable section 197 intangible under section 197(f)(5), new T's specified policy acquisition expenses for the year of the transaction equal $200.00 ($199.50 of other specified policy acquisition expenses for the year + $0.50 of assumed amortization expense under section 197, derived by treating one-half of the amount paid or incurred for the contract as a section 197 intangible for which an amortization deduction is allowed ($15.00 × ½ × 1⁄15)). To determine the amount required to be capitalized under section 848 in connection with the acquisition of the group contract, new T multiplies the $200 of specified policy acquisition expenses for the taxable year by a fraction, the numerator of which is $10.25 ($500 × 2.05%) and the denominator of which is $741.75 (($500 × 2.05%) + ($9,500 × 7.7%)). Thus, for purposes of applying section 197(f)(5), new T is treated as capitalizing $2.76 ($200 × $10.25 ÷ $741.75) under section 848 in connection with the acquisition of the group contract. Accordingly, the adjusted basis of the group contract under section 197(f)(5) is $12.24, the excess of the amount paid or incurred by the reinsurer for the group contract in the assumption reinsurance transaction ($15) over the amount treated as capitalized under section 848 in connection with the transaction ($2.76). New T amortizes the $12.24 adjusted basis of the group contract over 15 years under section 197. New T deducts the remaining $2.76 of the $15 of AGUB allocable to the contract because it is reflected in amounts new T capitalizes under section 848. In computing its actual capitalization under section 848 for the taxable year, new T takes into account its actual amortization under section 197 (i.e., $12.24 × 1⁄15 = $0.82) rather than the $0.50 assumed for the purpose of determining basis under section 197(f)(5).

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

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

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

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

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

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

(ii) *Analysis.* The indemnity reinsurance agreement constitutes a disposition of the section 197(f)(5) intangible because it involves the transfer of sufficient economic rights attributable to the insurance contracts to which the section 197(f)(5) intangible relates such that recovery of basis is allowed. For purposes of applying the loss disallowance rules of section 197(f)(1) and paragraph (g) of this section, new T's loss is $2 (new T's adjusted basis in the section197(f)(5) intangible immediately prior to the disposition ($12) less the ceding commission ($10)). Therefore, new T applies $10 of the adjusted basis in the section 197(f)(5) intangible against the amount received from R for the future income right on the reinsured policies and increases its basis in the amortizable section 197 intangibles that it acquired and retained from the deemed asset sale by $2, the amount of the disallowed loss. The amount of new T's disallowed loss under section 197(f)(1)(A) is determined without regard to the effect of the indemnity reinsurance transaction on the amounts capitalized by new T as specified policy acquisition expenses under section 848.

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

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

(iii) *Effective date.* This paragraph (g)(5) is applicable to acquisitions and dispositions on or after the date it is filed as a final regulation with the **Federal Register**. For rules applicable to acquisitions and dispositions on or before that date, *see* § 1.197–2 in effect prior to that date (*see* 26 CFR part 1, revised April 1, 2001).

* * * * *

Par. 4. Section 1.338–0 is amended by adding entries to the outline of topics for § 1.338–11 to read as follows:

§ 1.338–0 Outline of topics.

* * * * *

§ 1.338–11 Effect of section 338 election with respect to insurance company target.

(a) In general.
(b) Computation of ADSP and AGUB.
(1) Reserves as an assumed liability.
(2) Allocation of AGUB and ADSP to specific insurance contracts.
(c) Application of assumption reinsurance principles.
(1) In general.
(2) Reinsurance premium amount.
(3) Ceding commission.
(4) Examples.
(d) Reserve increases by new target after the deemed asset sale.
(1) In general.
(2) Exceptions.
(3) Increases in unpaid loss reserves.
(4) Increases in other reserves.
(5) DAC characteristics of the premium resulting from an adjustment.
(6) Subsequent dispositions of amortizable section 197 intangibles with respect to insurance contracts.
(7) Examples.
(e) Effect of section 338 election on old target's capitalization amounts under section 848.
(1) Determination of net consideration for specified insurance contracts.
(2) Determination of capitalization amount.
(3) Section 381 transactions.
(f) Effect of section 338 election on policyholders surplus account.
(g) Effect of section 338 election on section 847 special estimated tax payments.
(h) Effective date.

Par. 5. Section 1.338–1 is amended by revising the last two sentences of paragraph (a)(2) and adding a sentence before the last sentence of paragraph (a)(3), to read as follows:

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

(a) * * *

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

(3) * * * Section 1.338–11 provides special rules for insurance company targets. * * *

* * * * *

Par. 6. Section 1.338–11 is added to read as follows:

§ 1.338–11 Effect of section 338 election with respect to insurance company target.

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

(b) *Computation of ADSP and AGUB*—(1) *Reserves as an assumed liability.* For purposes of computing ADSP and AGUB under §§ 1.338–4 and 1.338–5, old target's reserves for Federal income tax purposes with respect to any insurance, annuity, and reinsurance contracts deemed sold by old target to new target in the deemed asset sale will be treated as liabilities of old target assumed by new target. Such reserves are those properly taken into account by old target with respect to such contracts at the close of the taxable year ending on the acquisition date (before giving effect to the deemed asset sale and assumption reinsurance transaction). Such reserves are hereinafter referred to as old target's tax reserves.

(2) *Allocation of AGUB and ADSP to specific insurance contracts.* For purposes of allocating AGUB and ADSP pursuant to §§ 1.338–6 and 1.338–7, the fair market value of a specific insurance, reinsurance or annuity contract or group of insurance, reinsurance or annuity contracts (hereinafter insurance contracts) is the amount of the ceding commission a willing reinsurer would pay a willing ceding company in an arm's length transaction for the reinsurance of the contracts if the gross reinsurance premium for the contracts were equal to old target's tax reserves for the contracts. See § 1.197–2(g)(5) for rules concerning the treatment of the amount allocable to insurance contracts acquired in the deemed asset sale.

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

(2) *Reinsurance premium amount.* In general, the gross amount of the premium paid by old target in the assumption reinsurance transaction is equal to the amount of old target's tax reserves with respect to the contracts deemed transferred from old target to new target, as computed in paragraph (b)(1) of this section. Thus, old target is entitled to a deduction for this amount, and includes in income the ceding commission, if any, deemed received from new target. New target is deemed to receive a reinsurance premium from old target in the amount of the reserves for the contracts and to pay old target the amount of any ceding commission, as computed in paragraph (c)(3) of this section.

(3) *Ceding commission.* Old target is deemed to receive a ceding commission in an amount equal to the amount of ADSP allocated to the insurance contracts transferred in the assumption reinsurance transaction, as determined under §§ 1.338–6 and 1.338–7 and paragraph (b) of this section. New target is deemed to pay a ceding commission in an amount equal to the amount of AGUB allocated to the insurance contracts acquired in the assumption reinsurance transaction, as determined under §§ 1.338–6 and 1.338–7 and paragraph (b) of this section.

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

Example 1—(i) *Facts.* On January 1, 2003, T, an insurance company, has the following assets with the following fair market values: $10 cash, $30 of securities, $10 of equipment, a life insurance contract having a value, under paragraph (b)(2) of this section, of $17, and goodwill and going concern value. T has tax reserves of $50 and no other liabilities. On January 1, 2003, P purchases all of the stock of T for $16 and makes a section 338 election for T. For purposes of the capitalization requirements of section 848, assume new T has $20 of general deductions in its first taxable year ending on December

31, 2003, and earns no other premiums during the year.

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

(B) Under section 1001, old T's amount realized with respect to the securities is $30 and with respect to the equipment is $10. As a result of the deemed asset sale, there is an assumption reinsurance transaction between old T (as ceding company) and new T (as reinsurer) at the close of the acquisition date with respect to the life insurance contract issued by old T. See paragraph (c)(1) of this section. Although the assumption reinsurance transaction results in a $50 decrease in old T's reserves, which is taxable income to old T, the reinsurance premium paid by old T is deductible by old T. Under paragraph (c)(2) of this section, old T is deemed to pay a reinsurance premium equal to the reserve for the life insurance contract immediately before the deemed asset sale ($50) and is deemed to receive a ceding commission from new T. Under paragraph (c)(3) of this section, the portion of the ADSP allocated to the life insurance contract is $16; thus, the ceding commission is $16. Old T, therefore, is deemed to pay new T a reinsurance premium of $34 ($50 − $16 = $34). Old T also has $34 of net negative consideration for purposes of section 848. See paragraph (e) of this section for rules relating to the effect of a section 338 election on the capitalization of amounts under section 848.

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

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

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

(B) Under section 1001, old T's amount realized with respect to the securities is $30 and with respect to the equipment is $10. As a result of the deemed asset sale, there is an assumption reinsurance transaction between old T (as ceding company) and new T (as reinsurer) at the close of the acquisition date with respect to the life insurance contract issued by old T. See paragraph (c)(1) of this section. Although the assumption reinsurance transaction results in a $50 decrease in old T's reserves, which is taxable income to old T, the reinsurance premium deemed paid by old T to new T is deductible by old T. Under paragraph (c)(2) of this section, old T is deemed to pay a reinsurance premium equal to the reserve for the life insurance contract immediately before the deemed asset sale ($50), and is deemed to receive from new T a ceding commission equal to the amount of AGUB allocated to the life insurance contract ($0), as provided in paragraph (c)(3) of this section. Old T also has $50 of net negative consideration for purposes of section 848. See paragraph (e) of section for rules relating to the effect of a section 338 election on capitalization amounts under section 848.

(C) New T obtains an initial basis of $30 in the securities and $10 in the equipment. New T is deemed to receive a reinsurance premium from old T in an amount equal to the $50 of reserves for the life insurance contract. Accordingly, new T includes $50 of premium in income and deducts $50 for its increase in reserves. For purposes of section 848, new T has $50 of net positive consideration with respect to the deemed assumption reinsurance transaction. Because the only contract involved in the assumption reinsurance transaction is a life insurance contract, new T must capitalize $3.85 ($50 × 7.7%) under section 848 from the transaction and deducts the remaining $16.15 of its general deductions. Because new T allocates $0 of the AGUB to the insurance contract, no amount is amortizable under section 197 with respect to the insurance contract. See paragraph (d) of this section for rules on adjustments required if, before the end of 2006, new T increases its reserves for, or reinsures at a loss, the acquired life insurance contract.

(d) *Reserve increases by new target after the deemed asset sale*—(1) *In general.* If, during any of its first four taxable years, new target increases its reserves for any insurance contracts acquired in the deemed asset sale (acquired contracts), new target shall be treated as receiving in that year the sum of the positive amounts, if any, described in paragraphs (d)(3) and (4) of this section as an additional premium for the acquired insurance contracts in the assumption reinsurance transaction (described in paragraph (c)(1) of this section) that occurred in connection with the deemed asset sale and will include such amount in income, and such amount will increase AGUB. *See* §§ 1.338–5(b)(2)(ii) and 1.338–7. Old target makes no adjustments to ADSP under this paragraph (d).

(2) *Exceptions.* New target is not required to take into account reserve increases under this paragraph (d)—

(i) To the extent such increases occur while it is under state receivership; or

(ii) To the extent its deduction for the reserve increase is spread under section 807(f) over the 10 succeeding taxable years.

(3) *Increases in unpaid loss reserves.* The amount of reserve increases, if any, taken into account under this paragraph (d) with respect to unpaid losses on acquired contracts is computed using the formula $A/B \times (C - [D + E])$ where—

(i) A equals old target's discounted unpaid losses (determined under section 846) used to compute the tax reserves included in AGUB under paragraph (b)(1) of this section;

(ii) B equals old target's undiscounted unpaid losses (as defined by section 846(b)(1)) used to compute the tax reserves included in AGUB under paragraph (b)(1) of this section;

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

(iv) D (which may be a negative number) equals the amount determined by—

(A) Multiplying old target's undiscounted unpaid losses (as defined by section 846(b)(1)) by 1.02 for new target's first taxable year, 1.04 for new target's second taxable year, 1.06 for new target's third taxable year, or 1.08 for new target's fourth taxable year; and

(B) Subtracting the cumulative amount of losses, loss adjustment expenses, and reinsurance premiums paid by new target through the end of the taxable year with regard to losses incurred by old target on or before the acquisition date; and

(v) E equals the cumulative amount of the undiscounted unpaid losses taken into account in prior taxable years by new target as adjustments to reserves with regard to losses incurred by old target on or before the acquisition date.

(4) *Increases in other reserves.* The amount of the increases in reserves other than unpaid loss reserves is taken into account under this paragraph (d) to the extent of any net increase (in the aggregate) in reserves for acquired contracts due to changes in methodology or assumptions used to compute the reserves for those contracts (including the adoption by new target of a methodology or assumptions different from those used by old target).

(5) *DAC characteristics of the premium resulting from an adjustment.* For purposes of applying section 848, the additional premium arising from the adjustment under this paragraph (d) is allocated among each category of specified insurance contracts under section 848(c)(1) (and contracts that are not specified insurance contracts) as follows—

(i) For each category of specified insurance contracts (and contracts that are not specified insurance contracts), by taking the sum of that category's contribution to the amounts in paragraphs (d)(3) and (4) of this section; and

(ii) Dividing the additional premium described in paragraph (d)(1) of this section in proportion to the positive sums for each category from paragraph (d)(5)(i) of this section.

(6) *Subsequent dispositions of amortizable section 197 intangibles with respect to insurance contracts.* For rules regarding subsequent dispositions of contracts acquired in the deemed asset sale, see also § 1.197–2(g)(5)(ii).

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

Example 1—(i) *Facts.* On January 1, 2003, P purchases all of the stock of T, a non-life insurance company, for $120 and makes a section 338 election for T. On the acquisition date, old T has total reserve liabilities under state law of $725, consisting of undiscounted unpaid losses of $625 and unearned premiums of $100. Old T's tax reserves on the acquisition date are $580, which consist of discounted unpaid losses (as defined in section 846) of $500 and unearned premiums (as computed under section 832(b)(4)(B)) of $80. Old T has assets in Classes I through V with a fair market value of $700. As of the beginning of January 1, 2003, old T also has Class VI assets with a value of $75, consisting of the future profit stream on certain insurance contracts. During 2003, new T makes loss adjustment expense payments of $200 with respect to the unpaid losses incurred by old T prior to the acquisition date. As of December 31, 2003, new T reports undiscounted unpaid losses of $435 attributable to losses incurred prior to the acquisition date. The related amount of discounted losses (as defined in section 846) for those losses is $360.

(ii) *Computation and allocation of AGUB.* Pursuant to § 1.338–5 and paragraph (b)(1) of this section, as of the acquisition date, AGUB is $700, reflecting the sum of the amount paid for old T's stock ($120) and the tax reserves assumed by new T in the transaction ($580). Under § 1.338–6, new T allocates the AGUB to each of the assets in Class I through V up to their fair market value. No AGUB is available for the assets in Class VI, even though the future profit stream on old T's insurance contracts has a fair market value of $75 on the acquisition date.

(iii) *Adjustments for increases in reserves with respect to unpaid losses.* Pursuant to paragraph (d) of this section, new T must determine whether any amounts by which it increased its unpaid loss reserves will be treated as an additional premium. New T applies the formula of paragraph (d)(3) of this section, where A equals $500, B equals $625, C equals $435, D equals $437.50 [($625 × 1.02) − $200], and E equals $0. Under the formula, new T is not subject to an adjustment for 2003 because new T's undiscounted unpaid losses at the end of the taxable year ($435) do not exceed $437.50, the adjusted amount of undiscounted unpaid losses used in computing AGUB reduced by loss payments through the end of the taxable year [($625 × 1.02) − $200].

Example 2—(i) *Facts.* Assume the same facts as in *Example 1*. Further assume that during 2004 new T deducts total loss and expense payments of $375 with respect to losses incurred by old T prior to the acquisition date. On December 31, 2004, new T reports undiscounted unpaid losses of $150 with respect to losses incurred prior to the acquisition date. The related amount of discounted unpaid losses (as defined in section 846) for those losses is $125.

(ii) *Analysis.* New T must determine whether any amounts by which it increased its unpaid loss reserves during 2004 will be treated as an additional premium under paragraph (d) of this section. New T applies the formula of paragraph (d)(3) of this section, where A equals $500, B equals $625, C equals $150, D equals $75 [($625 × 1.04) − $575], and E equals $0. Pursuant to paragraph (d) of this section, new T must recognize additional premium income in 2004 of $60.00 (($500/$625) × ($150—[$75+$0]) to offset the section 832(b)(5) deduction for amounts by which it increased those reserves and must adjust the amount of AGUB allocable to acquired insurance contracts (Class VI assets) to reflect the increase in AGUB attributable to the $60.00 adjustment for increases in reserves. See section 197 and the regulations thereunder for the treatment of the amounts allocable to the insurance contracts.

Example 3—(i) *Facts.* Assume the same facts as in *Example 2.* Further assume that on January 1, 2005, new T reinsures the outstanding liability with respect to losses incurred by old T prior to the acquisition date through a portfolio reinsurance transaction with R, another non-life insurance company. In this transaction, R agrees to assume any remaining liability with respect to losses incurred prior to the acquisition date in exchange for a reinsurance premium of $175. Accordingly, as of December 31, 2005, new T reports no undiscounted unpaid losses with respect to losses incurred by old T prior to the acquisition date.

(ii) *Analysis.* New T must determine whether any amounts by which it increased its unpaid loss reserves will be treated as an additional premium under paragraph (d) of this section. New T applies the formula of paragraph (d)(3) of the section, where A equals $500, B equals $625, C equals $0, D equals −$87.50 [($625 × 1.06) − ($575 + $175) = −$87.50], and E equals $75. New T must include $10.00 (($500/$625) × ($0 − [−$87.50 + $75]) in gross income for 2005 to offset the section 832(b)(5) deduction for increases to its unpaid loss reserve and must increase the AGUB allocable to the acquired insurance contracts (Class VI assets) by this amount. See section 197 and the regulations thereunder for the treatment of the amounts allocable to the insurance contracts.

(e) *Effect of section 338 election on old target's capitalization amounts under section 848*—(1) *Determination of net consideration for specified insurance contracts.* For purposes of applying section 848 and § 1.848–2(f) to the deemed assumption reinsurance transaction, old target's net consideration (either positive or negative) with respect to each category of specified insurance contracts is an amount equal to—

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

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

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

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

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

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

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

(g) *Effect of section 338 election on section 847 special estimated tax payments.* If old target had elected to claim an additional deduction under section 847 for taxable years prior to and including the acquisition date, the amount remaining in old target's special loss discount account under section 847(3) must be reduced to the extent it relates to contracts transferred to new target and the amount of such reduction must be included in old target's gross income for the taxable year that includes the deemed assumption reinsurance transaction. Old target may apply the balance of its special estimated tax account as a credit against any tax resulting from such inclusion in gross income. Any special estimated tax payments remaining after this credit are voided and, therefore, are not available for credit or refund. Pursuant to section 847(1), new target is permitted to claim a section 847 deduction with respect to losses incurred prior to the deemed asset sale, subject to the general requirement that new target makes timely special estimated tax payments equal to the tax benefit resulting from this deduction. *See* § 1.381(c)(22)-1(c)(14) regarding the carryover of the special loss discount account attributable to contracts transferred in a section 381 transaction.

(h) *Effective date.* This section applies to a section 338 election for a target if the acquisition date is on or after the date this section is filed as a final regulation with the **Federal Register**.

Par. 7. Section 1.381(c)(22)–1 is amended by:

1. Adding a sentence to the end of paragraph (b)(7)(i).
2. Redesignating existing (b)(7)(ii) as paragraph (b)(7)(iv) and adding new paragraphs (b)(7)(ii) and (b)(7)(iii).
3. Adding paragraphs (b)(7)(v), and (b)(13) and (b)(14).

The revisions read as follows:

§ 1.381(c)(22)–1 Successor life insurance company.

* * * * *

(b) * * *

(7)(i) * * * However, any amounts attributable to money or other property distributed to a person other than the acquiring corporation under section 381(a) (*e.g.,* boot) shall be treated as a distribution under section 815.

(ii) Notwithstanding paragraph (b)(7)(i) of this section, if the transferor corporation transfers less than 50 percent of its insurance business to the acquiring corporation, then the acquiring corporation shall succeed to a ratable portion of the dollar balances in the transferor's shareholders surplus account, policyholders surplus account, and other accounts. The percentage of such accounts to which the acquiring corporation succeeds is determined by the ratio of the transferor's insurance reserves for the contracts transferred to the acquiring corporation, as maintained under section 816(b), to the transferor's reserves for all of its contracts maintained under section 816(b) immediately before the earlier of the distribution or transfer or the adoption of the plan of liquidation or reorganization. For transactions in which the transferor liquidates pursuant to an election under section 338(h)(10), *see* § 1.338–11(f) for the treatment of its remaining policyholders surplus account. For all other transactions subject to this paragraph, the transferor must take into account as income its remaining policyholders surplus account to the extent the fair market value of its assets (net of liabilities) transferred to the acquiring corporation or to the transferor's shareholders pursuant to the plan of liquidation or reorganization exceeds the transferor's remaining shareholders surplus account.

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

* * * * *

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

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

Example 2. Assume the same facts as in *Example 1,* except that T holds a block of life insurance contracts P does not wish to acquire, and, immediately before the sale of T stock, S causes T to distribute the unwanted block of insurance contracts to S. Further, assume that S is an insurance company, that the distribution of contracts is treated as pursuant to a section 332 liquidation, and that old T's tax reserves with respect to the distributed contracts represent one-tenth of old T's tax reserves with respect to all of its life insurance contracts. Because T transfers less than 50 percent of its life insurance business to S pursuant to a section 332 liquidation, S succeeds to a ratable portion of old T's policyholders surplus account ($1), and old T includes as ordinary income the remaining $9 of that account.

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

* * * * *

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

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

Par. 8. Section 1.1060–1 is amended by:

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

The revision and addition read as follows:

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

(a) * * *

(2) *Effective dates.* In general, the provisions of this section apply to any asset acquisition occurring after March 15, 2001. However, paragraphs (b)(9) and (c)(5) of this section apply only to applicable asset acquisitions occurring on or after the date they are filed as final regulations with the **Federal Register**. For rules applicable to asset acquisitions on or before March 15, 2001, see § 1.1060–1T in effect prior to March 16, 2001 (see 26 CFR part 1 revised April 1, 2000).

(3) * * *

* * * * *

(b) * * *

(9) Insurance business.

(c) * * *

(5) Insurance business.

* * * * *

(b) * * *

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

(c) * * *

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

* * * * *

Robert E. Wenzel,

Deputy Commissioner of Internal Revenue.

[FR Doc. 02–5485 Filed 3–7–02; 8:45 am]

BILLING CODE 4830–01–P

DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 46

[REG–125450–01]

RIN 1545–AY93

Liability for Insurance Premium Excise Tax; Hearing Cancellation

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Cancellation of notice of public hearing on proposed rulemaking.

SUMMARY: This document provides notice of cancellation of a public hearing on proposed regulations relating to liability for insurance premium excise tax.

DATES: The public hearing originally scheduled for Tuesday, March 19, 2002, at 10 a.m., is cancelled.

FOR FURTHER INFORMATION CONTACT: Guy Traynor, Regulations Unit, Assistant Chief Counsel (Income Tax & Accounting), (202) 622–7180 (not a toll-free number).

SUPPLEMENTARY INFORMATION: A notice of proposed rulemaking and notice of public hearing that appeared in the **Federal Register** on January 7, 2002 (67 FR 707), announced that a public hearing was scheduled for March 19, 2002 at 10 a.m., in room 4718 of the Internal Revenue Building, 1111 Constitution Avenue NW., Washington, DC. The subject of the public hearing is proposed regulations under section 4371 of the Internal Revenue Code. The public comment period for these proposed regulations expired on February 26, 2002. The notice of proposed rulemaking and notice of public hearing, instructed those interested in testifying at the public hearing to submit a request to speak and an outline of the topics to be addressed. As of January 7, 2002, no one has requested to speak. Therefore, the public hearing scheduled for March 19, 2002 is cancelled.

Cynthia E. Grigsby,

Chief, Regulations Unit, Associate Chief Counsel, (Income Tax & Accounting).

[FR Doc. 02–5484 Filed 3–7–02; 8:45 am]

BILLING CODE 4830–01–P

LIBRARY OF CONGRESS

Copyright Office

37 CFR Part 201

[Docket No. RM 2002–1A]

Notice and Recordkeeping for Use of Sound Recordings under Statutory License

AGENCY: Copyright Office, Library of Congress.

ACTION: Extension of comment period.

SUMMARY: The Copyright Office of the Library of Congress is extending the time period for filing comments on its Notice of Proposed Rulemaking concerning requirements by which copyright owners shall receive reasonable notice of the use of their works from digital transmission services, and how records of such use shall be kept and made available to copyright owners.

DATES: Comments are due no later than April 5, 2002. Reply comments are due April 26, 2002.

ADDRESSES: If sent by mail, an original and ten copies of comments and reply comments should be addressed to: Copyright Arbitration Royalty Panel (CARP), P.O. Box 70977, Southwest Station, Washington, DC 20024. If hand delivered, comments and reply comments should be brought to: Office of the General Counsel, James Madison Building, Room LM–403, First and Independence Ave., SE., Washington, DC 20559–6000.

FOR FURTHER INFORMATION CONTACT: David O. Carson, General Counsel, or Tanya M. Sandros, Senior Attorney, Copyright Arbitration Royalty Panel (CARP), P.O. Box 70977, Southwest Station, Washington, DC 20024. Telephone: (202) 707–8380. Telefax: (202) 252–3423.

SUPPLEMENTARY INFORMATION: A sound recording may be publicly performed by means of a digital audio transmission under a statutory license provided that the user adheres to the terms of the license and the regulations established by the Copyright Office governing notice and recordkeeping. *See* 17 U.S.C. 114. On February 7, 2002, the Copyright