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by Vadim Mahmoudov and Daniel Priest

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In this report, Mahmoudov and Priest examine two non-insurance provisions that can menace an insurance company's deferred acquisition cost deductions and raise thorny issues of application — namely, the unified loss rules under reg. section 1.1502-36 and the built-in loss limitations of section 382.

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The question "What happens to the DAC?" probably will sound like gibberish to even the most seasoned tax lawyers (and even more so if they double as the sort of electronics geeks who regularly use a digital-to-analog converter). By statutory alchemy, the rules of section 848 capitalize a chunk of a life insurance company's business deductions and transform them into an amorphous attribute referred to as deferred acquisition cost (DAC) that, in isolation, simply rolls off over 10 years. But if the insurance company takes any major corporate actions during that period, it will have to evaluate how other tax rules affect DAC in the absence of clear authority.

DAC is a good example of one of the challenges of life insurance company taxation: Insurance companies are directly taxed under subchapter L, which is specifically designed to reflect the unique character of the industry, but they are also subject to many of the general provisions of subchapter C and the consolidation rules of section 1502.[1] The interaction between the general corporate tax and insurance tax regimes can be murky. This report examines two non-insurance provisions that can menace an insurance company's DAC deductions and raise thorny issues of application — namely, the unified loss rules under reg. section 1.1502-36 and the built-in loss limitations of section 382.

I. Background — DAC Rules

The DAC rules are intended to prevent a timing mismatch: An insurance company immediately deducts expenses incurred as part of its business of writing insurance policies, but it recognizes income over many years — as

[1]The regulations under section 1502 include some special consolidation rules for life insurance companies. *See* reg. section 1.1502-47.

investment and underwriting income earned over the life of the policy.[2] Congress has recognized that it is difficult to apportion general corporate overhead expenses (for example, an employee's salary) among the many insurance policies written by an insurance company and then force them to be amortized over the lives of the particular contracts.[3] Therefore, it adopted a rough justice approach. Generally, under section 848, a life insurance company takes its net premium income for a tax year from specified life insurance and annuity products, multiplies that amount by a fixed percentage, and capitalizes the resulting dollar amount of "specified policy acquisition expenses" (typically called DAC). That DAC amount is amortized on a straight-line basis over 10 years.[4]

As one commentator has noted, "deferred acquisition cost" is a misnomer, because it comprises general deductions attributable to an insurance company's ongoing operations.[5] These costs can and do include otherwise deductible expenses that bear no direct relation to the issuance of particular life insurance contracts or annuity policies, such as corporate overhead or interest deductions on debt.

II. DAC Versus Basis

"Capitalized into what?" the reader may ask. Expenses or losses that are required to be capitalized cannot, by definition, be deducted currently and are taken into account at a later point in time — if at all.[6] In the typical scenario, capitalized amounts, such as the costs of constructing a building, are added to the basis of an asset. However, in other contexts, capitalized amounts are taken into account in different ways. For example, the capitalized costs of a target in a taxable stock acquisition may be permanently nondeductible.[7] On the other hand, a borrower's capitalized debt issuance costs, if deductible, are treated as a reduction in issue price.[8] And capitalized amounts paid to facilitate the writing of an option are treated as a reduction in premiums received.[9] Practitioners typically think of unamortized DAC as either a floating deferred deduction, like a loss suspended under section 267(f), or akin to basis in an intangible asset. As this report will illustrate, the two theories can cause materially different results when applying other tax rules to DAC.

It could be argued that since the amortization of specified policy acquisition expenses is intended to match deductions to premium or investment income attributable to specified insurance contracts, the balance of unamortized deductions can be analogized to basis in the "specified insurance contracts" written by the insurance company in a given tax year. After all, the premiums from those policies determined the maximum amount of general deductions required to be deferred and amortized for that year.[10] However, we believe that specified policy acquisition expenses are fundamentally unlike asset basis because they are separate from any particular asset.

First, the costs that give rise to these general deductions are typically expensed for financial accounting purposes. In this regard, DAC is different from the cost basis of a particular asset, which is not expensed for financial accounting purposes but is recognized as an asset on the insurance company's financial balance sheet.

Second, as discussed above, simply because an amount is capitalized does not mean that it is necessarily added to the basis of any asset. The general deductions that comprise the specified policy acquisition expenses under section 848(c) are not related to the acquisition of the specified insurance contracts or other assets in any meaningful way.

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[2] *See* Staff of House Ways and Means Committee, "Legislative History of Ways and Means Democratic Alternative," at 27 (Comm. Print 1990).

[3] *Id*. at 28.

[4] Section 848(a).

[5] *See* Stephen C. Eldridge, "The New DAC Tax," 1991 Valuation Actuary Symposium Proceedings, at 265.

[6] *See*, *e.g.*, reg. section 1.263(a)-5.

[7] *See* reg. section 1.263(a)-5(g)(2)(ii)(B) (reserving on treatment); and Boris Bittker and Lawrence Lokken, *Federal Taxation of Income, Estates, and Gifts*, para. 106.5.5 (2d/3d ed. and 2017 Cum. Supp. No. 1) (arguing that permanent nondeductibility is the correct treatment).

[8] Reg. section 1.446-5(b)(1).

[9] Reg. section 1.263(a)-5(g)(5).

[10] Section 848(a) and (c).

Finally, "basis" is not an asset for federal income tax purposes — it is fundamentally inseparable from the tangible or intangible property to which it relates.[11] When the asset is disposed of, basis either reduces the gain on the disposition of the asset or, to the extent that the amount realized is less than basis, results in a current loss. But in either case, the company that incurred a cost to acquire an asset will not retain old basis after the asset associated with the basis is disposed of in a taxable transaction.[12] To the contrary, if a specified insurance contract that generated the premiums that gave rise to DAC is settled or simply terminated (for example, on the death of the insured or as a result of nonpayment of premiums), the DAC balance that may be attributable to the settled contract is not immediately deducted or otherwise taken into account for federal income tax purposes. Instead, it remains on the tax books of the insurance company and continues to be amortized over the 120-month period specified in section 848. Expenses capitalized under section 848 can be separated from the specified insurance contracts that resulted in the deferral of deductions in several other ways, as discussed below.

A. DAC in Reinsurance Transactions

By reinsuring the risks under a given insurance contract to another insurance company (the reinsurer), the original insurer (the ceding company) can transfer the economic benefits and burdens of the contract. If the ceding company pays more consideration to the reinsurer than it receives, it generally offsets the premiums received from the underlying insurance contract by the amount of this net payment, resulting in a current deduction of amounts that otherwise would have been partially capitalized under DAC rules.[13] (The reinsurer must capitalize its own deductions in an amount equal to the relevant percentage of the net consideration received, thus restoring symmetry.) If the net consideration paid to the reinsurer exceeds the premiums paid by the underlying policyholder in a given year, the DAC capitalization requirement arising from premiums received from *other* reinsurance contracts in the same year can be turned off as well.[14] If the consideration is large enough to offset all the premiums received by the ceding company during the year, DAC balances arising in prior years are also written off, which accelerates the previously deferred deductions.[15]

Accordingly, the balance of capitalized expenses attributable to a block of insurance contracts can be written off upon the reinsurance of liabilities under completely different contracts, even if those contracts are entered into years apart. This is starkly different from asset basis, which generally is unaffected by the disposition of unrelated assets.

On the other hand, if an insurance company cedes insurance liabilities to a reinsurer that is not subject to net U.S. taxation, net consideration attributable to the reinsurance will not reduce its DAC balance.[16] Even if the reinsurer is subject to net U.S. taxation, if it lacks sufficient general deductions to capitalize the new DAC, the amount of consideration the ceding company may take into account in deducting its own DAC balance may be reduced as a result of the shortfall.[17] In that case, the ceding insurance company retains and continues to amortize some or all of its DAC balance even after disposing of the insurance contracts that resulted in its creation. Again, this generally does not happen to the basis of a disposed asset.

The treatment of DAC in a reinsurance transaction contrasts with the treatment of basis created under section 197. If an insurance company acquires a block of insurance contracts that are subject to the DAC rules in an assumption reinsurance transaction, it will create an amortizable section 197 intangible asset (consisting of basis in the insurance in force) owned by the acquirer in an amount equal to the

[11] *Cf.* section 1012(a).

[12] *Cf.* sections 1012 and 358.

[13] Section 848(d)(1).

[14] Section 848(d)(1) and (f)(1)(A).

[15] Section 848(f)(1)(B).

[16] Reg. section 1.848-2(h)(1)-(2). A reinsurer that is not subject to U.S. tax cannot establish its own DAC balance, breaking the symmetry described above.

[17] Reg. section 1.848-2(g). This result may be avoided by a special election whereby the reinsurer agrees to capitalize other deductions instead, such as the deduction for increases in insurance reserves. Reg. section 1.848-2(g)(8).

excess of (1) the amount paid or incurred by the acquirer under the assumption reinsurance transaction (the ceding commission) over (2) the amount required to be capitalized under section 848 in connection with that transaction.[18] DAC is specifically excluded from section 197 treatment.[19] Thus, an assumption reinsurance transaction creates basis in a section 197 intangible, which is separate and distinct from the DAC required to be capitalized in connection with the transaction.

Moreover, if the acquirer of insurance contracts in a transaction governed by section 197 (assumption reinsurance) transfers through retrocession the right to future income (and other economic rights) from the insurance contracts to which the section 197(f)(5) intangible relates, that second transaction will constitute a disposition of the intangible, and the insurance company will be entitled to recover the basis of the intangible by way of offset against the proceeds.[20] However, the DAC balance created in the assumption reinsurance transaction continues to be governed by normal section 848 rules and may be completely unaffected by the subsequent disposition of the contracts. Thus, after the subsequent retrocession, the DAC and the insurance business can be in two separate corporate taxpaying entities, unlike basis in the section 197(f)(5) intangible, which is treated in a manner more consistent with asset basis.

B. DAC in Section 338 Transactions

If a corporation sells the stock of a subsidiary that is an insurance company subject to a section 338 election, all the assets of the subsidiary will be deemed to have been sold to an unrelated person, and the subsidiary is treated as having liquidated (generally under section 332, unless the subsidiary was insolvent). As part of the deemed asset sale:

> [T]he 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 . . . as modified by the rules set forth in [reg. section 1.338-11].[21]

Basis is not assigned to DAC under the section 338 rules. The baseline regulations governing the calculation and allocation of aggregate deemed sale price and adjusted grossed-up basis (AGUB) for a section 338 transaction with an insurance company target do not mention DAC.[22] Old Target's unamortized DAC balance is not transferred as an asset to which AGUB is allocated. Instead, Old Target and New Target adjust their DAC exactly as they would if they had engaged in an actual assumption reinsurance transaction under the terms specified in reg. section 1.338-11: The party paying net consideration for the transfer of insurance decreases its DAC balance, and the party receiving net consideration increases its DAC.[23] This is clearly demonstrated in examples 1 and 2 of reg. section 1.338-11(c)(4), which go through "typical" section 338 calculations for an insurance company.

The regulations governing the treatment of DAC in a section 338 transaction expressly contemplate that even after it has disposed of all its insurance in force, Old Target can still have remaining unamortized DAC.[24] If the selling corporation is not an insurance company and if, after the asset sale deemed to occur under section 338, Old Target has remaining unamortized DAC, Old Target deducts that remaining amount as an expense.[25] Under the successor insurance company rules of section 381, if the selling corporation is an insurance company, the selling corporation will succeed to Old Target's DAC

[18] Section 197(f)(5); reg. section 1.197-2(g)(5)(ii). In assumption reinsurance, an insurance contract is transferred from one insurer to another in a transaction in which the liability of the transferor to the underlying policyholders is extinguished and the liability is directly assumed by the transferee.

[19] Section 197(f)(5).

[20] Reg. section 1.197-2(g)(5)(iii)(A).

[21] Reg. section 1.338-11(c)(1).

[22] *See* reg. section 1.338-11(b).

[23] Reg. section 1.338-11(f)(1).

[24] *Id.*

[25] Reg. section 1.338-11(f)(2)(i).

balance even though the parent no longer has any ownership interest in the assets of the subsidiary.[26] The DAC balance travels up to the seller parent in the deemed liquidation of Old Target.

By contrast, the basis in the assets of the subsidiary is fully taken into account in determining the amount of gain or loss recognized on the deemed sale of assets and is not inherited by the seller. Basis is not an asset or method that is carried over under section 381.[27] The fact that in some circumstances DAC balances transfer under section 381 (whether or not as a result of a section 338 election) supports the conclusion that the balance of unamortized DAC is not treated as basis, even if in some other circumstances the balance of unamortized DAC is currently expensed as a result of a section 338 election (for example, if the seller is not an insurance company).

III. DAC and the Unified Loss Rule

On September 17, 2008, Treasury issued regulations under section 1502 implementing the so-called unified loss rule (ULR).[28] The purpose of the ULR was to "prevent the consolidated return provisions from reducing a group's consolidated taxable income through the creation and recognition of noneconomic loss on [subsidiary] stock . . . [and] to prevent members (including former members) of the group from collectively obtaining more than one benefit from a single economic loss."[29]

For example, if a corporation contributed $100 to its subsidiary that then used the cash to buy an asset that lost $75 of value, the corporation could sell the subsidiary to a third party for $25 and claim a capital loss of $75. If the purchaser caused the subsidiary to sell its asset for $25, the subsidiary would also have a capital loss of $75, permitting two different taxpayers to enjoy a deduction for a single economic loss (subject to built-in loss limitations under section 382, as discussed below). Similarly, the ULR operates to prevent the duplication of tax benefits from a single tax deduction — which can occur if deductible expenses that were incurred economically before the sale of a subsidiary are (because of a deferral provision) deductible for tax purposes only after a subsidiary is sold.

To prevent the loss duplication described above, the regulations generally provide that if a member of a U.S. consolidated group transfers a subsidiary's shares and the tax basis of these shares exceeds their value, tax attributes of the transferred company (or its subsidiaries) will be reduced by the lesser of (1) the amount by which the basis of the shares exceeds their fair market value and (2) the amount by which the net inside attribute amount exceeds the FMV of the shares.[30] Capital loss carryovers, net operating loss carryovers, deferred deductions, and asset basis are all subject to reduction.

The parent of the selling consolidated group may prevent attribute reduction by electing to reduce its basis in the subsidiary's stock. Alternatively, the parent may elect to reattribute to itself some or all of the transferred company's reduction-eligible attributes, other than asset basis (the reattribution election).[31] The reattribution is treated as a noncapital, nondeductible expense and thus reduces the outside basis in the stock of the transferred member and the capital loss on the stock sale.[32] The reattribution election can be an effective tool for optimizing value for the parties to a sale if the seller values tax attributes more highly than the buyer does, especially because reattributed items would be subject to section 382 limitations in the hands of the transferred company after the ownership change. Because the election is made by the parent of the selling group, it can also be a trap for an unwary buyer.

A. How Does the ULR Apply to DAC?

When an insurance company is sold from a consolidated group, unamortized DAC balances represent amounts that have been paid or incurred economically and for financial statement

[26] Reg. section 1.381(c)(22)-1(b)(13).

[27] *See* section 381(c). Assets may be transferred under section 332 or in a reorganization with a carryover basis, but basis itself is not something that can be transferred without an associated asset.

[28] T.D. 9424.

[29] Reg. section 1.1502-36(a)(2).

[30] Reg. section 1.1502-36(c)(5) and -36(d)(1)-(3).

[31] Reg. section 1.1502-36(d)(6)(i)(B).

[32] Reg. section 1.1502-36(d)(6)(iv) and -32(b)(2).

purposes (and therefore borne by the selling group) but that have not yet resulted in a tax deduction or a corresponding reduction in the tax basis of subsidiary's shares under reg. section 1.1502-32. Thus, the deferral of those deductions can result in an increased loss on the sale of the subsidiary's stock and a second tax benefit to the acquirer when the target insurance company claims the deferred deductions after the sale. For this reason, as a policy matter, practitioners generally take the view that DAC is subject to reduction under the ULR, although DAC is not specifically referenced in the rules or any published authority.

But it is less clear whether DAC is treated as a deferred deduction or as asset basis for purposes of the ULR. The principal difference is that a deferred deduction is eligible for the reattribution election, but asset basis is not. (It is also worth noting that under the ULR ordering rules, deferred deductions are eliminated before asset basis.) As previously discussed, we believe DAC should not be viewed as asset basis. We believe it is properly viewed as a deferred deduction.

A deferred deduction is defined as "any deduction for expenses or loss that would be taken into account under general tax accounting principles as of the time of the transfer of the share, but that is nevertheless not taken into account immediately after the transfer by reason of the application of a deferral provision."[33] Examples of deferred deductions provided in the Treasury regulations illustrate that deferred deductions are intended to include a broad sweep of tax attributes. The regulations list sections 267(f) and 469, as well as reg. section 1.1502-13, as examples of applicable deferral provisions. Also, the regulations indicate that the definition of deferred deductions includes not only actual deductions but also amounts equivalent to deductions, "such as negative adjustments under section 475 (mark-to-market accounting method for dealers in securities) and section 481 (adjustments required by changes in method of accounting)."[34]

[33]Reg. section 1.1502-36(f)(2).

[34]*Id.*

The examples provided in the regulations are a nonexclusive list, and the preamble to the regulations providing for the reattribution election indicates that "the IRS and Treasury Department intend these elections to be as flexible as possible."[35] Deductions for specified policy acquisition expenses meet the plain language of the definition of deferred deductions. Specified policy acquisition expenses are ordinary and necessary business expenses, or other operating expenses of the target company, that would have been deducted currently before the acquisition under general tax accounting principles. Their deductibility was deferred for up to 10 years because of the section 848 deferral provision.

B. Can DAC Be Moved to Another Company?

Even if DAC is treated as a deferred deduction, it must be mechanically possible to reattribute the DAC to the parent of the consolidated group and for the parent to deduct it after reattribution for the election to be beneficial. This poses a logical challenge when the parent of the group is not an insurance company: The DAC amortization regime is provided under subchapter L, and the subchapter C rules do not specifically address whether it is possible for a non-insurance company to succeed to DAC. However, there are strong arguments for reattribution.

Under the regulations, if a reattribution election is made, reattributed deductions are taken into account by the common parent of the electing group as if transferred in a section 381 transaction.[36] Nothing in the regulations limits the attributes eligible for reattribution to the attributes enumerated in section 381, though; any attribute that meets the definition of deferred deduction is reattributable.[37] The reference to section 381 — located in the subsection titled "Special rules for reattribution elections" — merely describes the process by which an eligible attribute is taken into account by the parent of the consolidated group. The parent steps in to the shoes of the target company as if the asset had

[35]T.D. 9424.

[36]Reg. section 1.1502-36(d)(6)(iv)(A).

[37]Reg. section 1.1502-36(d)(6)(i)(B).

been reattributed in a transaction described in section 381. But even if this language were interpreted as imposing a requirement that an eligible attribute be transferrable in a section 381 transaction, DAC would meet that requirement.

Under section 381, the unamortized DAC balance of a merging or liquidating insurance company is carried over to a successor insurance company.[38] The section 381 regulations do not address the merger or liquidation of an insurance company into a corporation that is not an insurance company. As a matter of state law and regulation, it is highly unlikely that an insurance company could actually be liquidated or merged into a non-insurance company. But the Treasury regulations do address the treatment of a transaction in which an insurance company can be deemed to liquidate into a non-insurance company for purposes of section 381 — the deemed liquidation that occurs as a result of a section 338 election. As previously discussed, Old Target should generally be treated as having liquidated under section 332 (a transaction to which section 381 applies); a seller that is an insurance company will then succeed to any remaining DAC, whereas a non-insurance company seller will deduct it in the year of the sale.[39] Arguably, this suggests that if a selling parent elects to reattribute DAC to itself, under the most analogous rule for a section 381 transaction involving a non-insurance successor to an insurance company, it would be eligible to deduct currently the entire DAC balance.

However, we believe the regulations' reference to section 381 reflects an intention that the reattributing parent step in to the shoes of the target subsidiary regarding the deferred deductions. Thus, it seems to us more consistent with the purpose of the reattribution election for the selling group to amortize the balance of the unamortized DAC on the same schedule the target subsidiary would have used, in the manner prescribed by the proposed section 381 regulation described above.

Permitting the reattribution and amortization is also consistent with the statement in the preamble that the IRS and Treasury intend the reattribution election to be as flexible as possible.[40] As noted above, even if the parent of a consolidated group that makes a reattribution election is not an insurance company, the relevant regulations provide that the parent "succeeds to any reattributed attributes *as if* such attributes were succeeded to in a transaction to which Section 381(a) applies."[41] Because a corporation can succeed to capitalized specified policy acquisition expenses in a section 381 transaction, the parent of the consolidated group should be treated as having succeeded to the capitalized specified policy acquisition expenses.

As described above, the general deductions that comprise capitalized specified policy acquisition expenses are by definition deductions that are not limited to insurance companies under subchapter L; they are ordinary deductions that are generally available to all corporate taxpayers.[42] Thus, we do not see anything untoward in having a subchapter C corporation succeed to and deduct those deferred expenses.

IV. DAC and Section 382

Section 382 limits the ability of a corporation that has experienced an ownership change to offset subsequent taxable income with pre-change losses. The policy underlying section 382 represents a desire to prevent tax-motivated trafficking in corporations that have NOL carryovers or other taxpayer-favorable attributes. When section 382 applies to an insurance company, two detriments may result. First, the company may have to pay more taxes because its loss use is limited. Second, the admitted deferred tax asset on the company's statutory balance sheet may need to be reduced. For purposes of this report, we focus on section 382's potential impact on a life insurance company's ability to continue amortizing its existing DAC balance after the company undergoes an ownership change.

There are two potential theories for applying section 382 limitations to DAC amortization deductions, both arising under the built-in loss

[38]Reg. section 1.381(c)(22)-1(b)(13).

[39]Reg. section 1.338-1(a)(1), 1.338(h)(10)-1(d)(4)(i), and 1.338-11(f)(2)(i); *see also* reg. section 1.338(h)(10)-1(e), Example 2.

[40]T.D. 9424.

[41]Reg. section 1.1502-36(d)(6)(iv)(A) (emphasis added).

[42]Section 848(c)(2).

rules of section 382(h). The first is to treat DAC as a recognized built-in loss (RBIL) under section 382(h)(2), and the second is to treat it as a built-in deduction under section 382(h)(6). In either case, the limitations would only apply to the extent that the company has an overall net unrealized built-in loss (NUBIL) as defined in section 382(h)(1)(B), and they generally apply only to deductions triggered during the five-year recognition period following the ownership change. If the company is instead in a net unrealized built-in gain (NUBIG) position, section 382 cannot limit the use of built-in losses.

A. DAC as RBIL: Asset Basis Redux

An RBIL is generally any loss recognized on the disposition of an asset that was held by the corporation immediately before the ownership change date, to the extent that the asset's basis exceeded its FMV on that date. Section 382(h) specifies that depreciation and amortization deductions during the recognition period are also treated as RBILs to the extent of the underwater excess of basis over value on the ownership change date.

To treat DAC amortization as an asset-based RBIL, one must conclude that (1) the DAC balance represents basis in an asset, (2) the asset's basis exceeds its value, and (3) the annual DAC deductions constitute amortization of that asset. Presumably, the asset in question would be the insurance company's business in force on the ownership change date — that is, the value of business acquired (VOBA), or "value of in-force," in accounting-speak.

For the reasons discussed above, we do not believe this asset basis theory is the better view. The DAC balance is not tied to any particular asset, and it can sometimes travel or remain in place without its related insurance contract. Moreover, in asset acquisitions, section 197 assigns tax basis to VOBA but specifically carves out the DAC balance.

Notably, it may be in taxpayers' interest to argue for asset basis treatment instead of treating the DAC amortization as a built-in deduction. This way, to the extent the VOBA has value, only the underwater portion of its amortization would be limited — and if the VOBA is sufficient to make it a built-in gain asset, no limitations would apply at all.

B. DAC as Built-In Deduction: A Stronger Case

Section 382(h)(6)(B) extends RBIL treatment to "any amount which is allowable as a deduction during the recognition period . . . but which is attributable to periods before the change date." It was added to the code in 1988 — two years after the modern section 382 was enacted. Initially, section 382 did not include this specific provision but granted Treasury authority to define the universe of built-in deductions. The legislative history of section 382 describes what Congress had in mind:

> The Treasury Department is authorized to issue regulations under which amounts that accrue before the change date, but are allowable as a deduction on or after such date (e.g., deductions deferred by section 267 or section 465), will be treated as built-in losses.[43]

The Treasury regulations have provided relatively little guidance on what constitutes a built-in deduction for this purpose. The most detailed explanation appears in the consolidated return rules applying section 382 to consolidated groups:

> The determination whether a consolidated group . . . has a [NUBIG or NUBIL] . . . is based on the aggregate amount of the separately computed [NUBIGs or NUBILs] of each member that is included in the group . . . including items of built-in income and deduction described in section 382(h)(6). Thus, for example, amounts deferred under section 267, or under [reg. section] 1.1502-13 . . . are built-in items.[44]

The consistent references to section 267 in this regulation and in the legislative history suggest that DAC amortization should be treated as a built-in deduction. Both sections 267 and 848 defer deductions for expenses that have otherwise

[43] H.R. Rep. No. 99-841, at II-191 (1986) (emphasis added).

[44] Reg. section 1.1502-91(g)(1).

accrued economically and would have otherwise been deducted but for a specific code provision that overrides general tax principles.

However, the most comprehensive government guidance on built-in losses is Notice 2003-65, 2003-2 C.B. 747. Notice 2003-65 offers two alternative methods for applying section 382(h): the "1374 approach" and the "338 approach." The notice addresses built-in deductions in its description of the 1374 approach and seems to take a narrower view than the plain language of the code:

> The 1374 approach generally relies on the accrual method of accounting to identify . . . deduction items as . . . RBIL. . . . Under this approach, items of . . . deduction . . . are considered "attributable to periods before the change date . . . *if an accrual method taxpayer would have . . . been allowed a deduction for the item before the change date.*"[45]

This language, taken literally, suggests that an accrual method taxpayer escapes section 382(h) for any deductions that were not allowed before the change date, regardless of whether the deductions were deferred under the DAC rules.[46] The language conforms to a provision under section 1374, a regime designed to tax subchapter S corporations that converted from subchapter C status on built-in gains attributable to their subchapter C periods. Generally, section 1374 measures NUBIG by looking at the aggregate excess of the FMV of an S corporation's assets over its tax basis and adjusts for some items such as built-in deductions. The relevant regulations under section 1374 do in fact treat a deduction as a built-in deduction only if it would have been "allowed as a deduction . . . to an accrual method taxpayer."[47]

But that is only the general rule. Section 1374 regulations then carve out an exception for deductions that met the all-events test for accrual before the subchapter S election but were deferred under section 267 or 404(a)(5); despite not being allowed as deductions when originally accrued, these items are still treated as built-in deductions when they are finally allowed.[48] Notably, this carveout omits mentioning deductions deferred under section 848, leading some tax advisers to argue that the general section 1374 rule applies to those deductions and that they are therefore not built-in deductions. Although technically accurate, that argument is perhaps too clever: The subchapter S regime is unavailable to insurance companies,[49] so it would be odd for those rules to mention DAC amortization. As a section 382 policy matter, it is difficult to distinguish a deduction deferred under the DAC rules from deductions deferred under sections 267 and 404(a)(5). In each case, the item was economically accrued (and probably paid) before the ownership change, leaving behind a pregnant tax attribute that could motivate loss trafficking.

Moreover, under the section 1374 regime, which targets built-in gains and makes them subject to corporate tax, a built-in deduction is an attribute favorable to the taxpayer. Thus, it is understandable that the applicable regulations generally define it narrowly. In the section 382 world that seeks to identify and quarantine pre-change losses, however, the government's interest is the opposite: to sweep in as many deductions as possible. It seems clear that Congress intended all deferred deductions (which by definition have not yet been allowed to an accrual method taxpayer) to be included as built-in deductions for purposes of section 382(h) so they could be limited. Accordingly, if the language of Notice 2003-65 can be read to exclude specific deferred deductions, it is inconsistent with legislative intent. Yet this seems to be the current Treasury position on the issue, and some taxpayers have been happily taking advantage of that interpretation.

The alternative 338 approach permitted by Notice 2003-65 compares the corporation's actual items of income and deduction with those that

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[45] Notice 2003-65, at III.B.2.a. (emphasis added).

[46] Notice 2003-65 deals separately with depreciation and amortization deductions and treats them as RBILs consistent with the code. *See id.* at III.B.2.a.(ii). Accordingly, treating the DAC balance as asset basis should result in DAC amortization being subject to section 382 limitations to the extent the VOBA is a built-in loss asset.

[47] *See* reg. section 1.1374-4(b)(2) (defining built-in deductions for purposes of section 1374).

[48] *See* reg. section 1.1374-4(c)(1) and (2).

[49] Section 1361(b)(2)(B).

would have resulted from a section 338 election for a hypothetical purchase of the corporation's stock on the ownership change date. Thus, deductions for contingent liabilities that existed on that date may be treated as RBILs, since a deemed assumption of that liability resulting from a section 338 election would have triggered a deduction. Similarly, if an insurance company would have been able to write off its DAC balance because of the deemed assumption reinsurance under section 338 rules, as described above, the DAC amortization deductions would be treated as RBILs.

On the other hand, the 338 approach may be beneficial to those who believe in the asset basis treatment of DAC. In determining the amount of depreciation or amortization deductions that should be treated as RBILs, the 338 approach looks to the excess of actual depreciation deductions over the amount that would have been allowed as depreciation had a section 338 election been made. Thus, if DAC is viewed as basis in VOBA, and VOBA is an appreciated asset on the ownership change date, none of the DAC amortization is limited. Again, this fantastic result depends on being comfortable with an asset basis position.

In sum, we believe there is a significant risk of DAC amortization being treated as a built-in deduction, and therefore being entirely subject to the RBIL limitations of section 382(h), after an insurance company undergoes an ownership change. A prospective buyer of such a company would be well-advised to evaluate whether the target company may be in a NUBIL position post-closing and, if so, how much of its DAC amortization may be subject to section 382 limitations.

If the seller is subject to the ULR, one way to potentially eliminate the issue would be to allow the seller to reattribute to itself the unamortized DAC balance. The seller may place a higher value on those deductions than the buyer does, since they may become limited in the buyer's hands after the closing. Thus, the buyer may increase its economic purchase price without sacrificing an asset that is worth much to it by allowing the seller to pull out and retain the DAC. The end result could be a win-win.

V. Conclusion

In a perfect world, the impact of any new tax rule on insurance companies would be taken into account during the legislative or rulemaking process — or, failing that, government guidance would clearly address the matter. In the real world, though, some uncertainties in coordinating the subchapter C and L regimes are inevitable. There will always be some reason to worry about the effect of a transaction on an insurance company's DAC balance. Practitioners should analyze the relevant tax provision in light of its intent and the nature of DAC, including DAC's behavior in analogous areas in which treatment is clear. ■