Internal Revenue Service
Number: **200052015**
Release Date: 12/29/2000
Index Number: 332.00-00, 368.05-00
1502.75-10

Department of the Treasury

Washington, DC 20224

Person to Contact:

Telephone Number:

Refer Reply To:
CC:CORP:B02-PLR-119822-99
Date:
September 27, 2000

LEGEND:

Mutual =

Stock Holding 1 =

Stock Holding 2 =

Subsidiary 1 =

Subsidiary 2 =

Subsidiary 3 =

Subsidiary 4 =

State X =

Y% =

Z% =

Business A =

$U =

Year V =

Year W =

PLR-119822-99

Dear:

This letter is in reply to a letter dated December 15, 1999, regarding the federal income tax consequences of a proposed transaction. Additional information was submitted in letters dated February 16, May 3, May 24, and June 12, 2000. The information submitted for consideration is summarized below.

Mutual is a mutual insurance company organized under the law of State X. Mutual is an accrual basis, calendar-year taxpayer and is the common parent of an affiliated group of corporations that file a consolidated Federal income tax return. The sole asset of Mutual is the stock of Stock Holding 1.

As a mutual insurance company, Mutual has no authorized, issued or outstanding capital stock. Rather, it has members who are the policyholders The membership interests in Mutual include voting rights and the right to participate in the distributions of Mutual surplus in the event of Mutual voluntary dissolution or liquidation.

Stock Holding 1 is organized under the law of State X and is a wholly-owned subsidiary of Mutual Stock Holding 1's assets consist primarily of 100% of the stock of Subsidiary 2, Subsidiary 3, and Subsidiary 4, and Y% of the stock of Stock Holding 2.

Stock Holding 2 is a publicly traded insurance holding company organized under State X law. Stock Holding 2 is an accrual basis, calendar-year taxpayer and is the common parent of an affiliated group of corporations. The principal assets of Stock Holding 2 consist of the stock of its wholly-owned subsidiaries which are all involved in Business A. Stock Holding 2 and those subsidiaries that are not life insurance companies file a consolidated Federal income tax return.

For what are represented as valid business reasons, Mutual has decided to convert from a mutual insurance company to a stock insurance company. Accordingly, Mutual proposes the following:

(i) Stock Holding 1 will liquidate into Mutual

(ii) Mutual will convert under State X law into a stock insurance company (the "Conversion"). The rights of Mutual Members will be extinguished and the Eligible Members will receive, in the aggregate, voting common stock that will ultimately represent Y% of Mutual and approximately $U of cash or policy credits funded by Mutual and

(iii) Stock Holding 2 will merge into Mutual by means of a statutory merger under State X law. The public shareholders of Stock Holding 2 will receive voting common stock of Mutual representing approximately Z% of the corporation

In calculating the amount of consideration to be received by each Eligible Member in the Conversion, shares of Mutual voting common stock will be allocated among all the Eligible Members entitled to receive consideration in accordance with the terms of the Plan of Conversion and actuarial computations. As described in the Plan of Conversion, Eligible Members shall be entitled to receive either shares of Mutual voting common stock, cash, or policy credits, in exchange for their membership interests.

In the case of membership interests associated with Qualified Contracts, Eligible Members shall receive only policy credits. Eligible Members with mailing addresses outside of the United States or with an address to which mail is undeliverable and Eligible Members known to be in bankruptcy proceedings or whose policy is subject to a creditor lien will receive solely cash in exchange for their membership interests. All other Eligible Members will be entitled to receive cash, Mutual stock, or a combination thereof, based upon their election and funds availability.

With regard to the liquidation of Stock Holding 1 into Mutual the taxpayer has made the following representations:

(a) Mutual on the date of adoption of the plan of liquidation, and at all times until the final liquidating distribution is completed, will be the owner of at least 80% of the single outstanding class of Stock Holding 1 stock.

(b) No shares of Stock Holding 1 stock will have been redeemed during the three (3) years preceding the adoption of the plan of liquidation of Stock Holding 1.

(c) All distributions from Stock Holding 1 to Mutual pursuant to the plan of complete liquidation will be made within a single taxable year of Stock Holding 1.

(d) As soon as the first liquidating distribution has been made, Stock Holding 1 will cease to be a going concern and its activities will be limited to winding up its affairs, paying its debts, and distributing its remaining assets to its shareholders.

(e) Stock Holding 1 will retain no assets following the final liquidating distribution.

(f) The liquidation of Stock Holding 1 will not be preceded or followed by the reincorporation in, or transfer or sale to, a recipient corporation of any of the businesses or assets of Stock Holding 1.

(g) Prior to adoption of the plan of liquidation, no assets of Stock Holding 1 will have been distributed in kind, transferred or sold to Mutual except for (i) transactions occurring in the normal course of business, and (ii) transactions occurring more than 3 years prior to adoption of the plan of liquidation.

(h) Stock Holding 1 will report all earned income represented by assets that will be distributed to its shareholders such as receivables being reported on a cash basis, unfinished construction contracts, commissions due, etc.

(i) The fair market value of the assets of Stock Holding 1 will exceed its liabilities both at the date of the adoption of the plan of complete liquidation and immediately prior to the time the first liquidating distribution is made.

(j) There is no intercorporate debt existing between Mutual and Stock Holding 1 and none has been canceled, forgiven, or discounted, except for transactions occurring more than three years prior to the date of adoption of the plan of liquidation.

(k) Mutual is not an organization that is exempt from Federal income tax under Section 501 or any other provision of the Code.

(l) All other transactions undertaken contemporaneously with, in anticipation of, in connection with, or in any way related to the proposed liquidation of Stock Holding 1 have been fully disclosed.

With regard to the conversion of Mutual from a mutual insurance company to a stock insurance company, as described above, the taxpayer has made the following representations:

(m) The fair market value of the Mutual stock received by its members, together with the cash and policy credits, will approximately equal the fair market value of the proprietary interests in Mutual surrendered in the exchange.

(n) The Conversion is not part of a plan to increase the proportionate interest of any owner in the assets or earnings and profits of Mutual

(o) Following the Conversion, Mutual will continue (as a stock insurance company) to be a company.

(p) Mutual and its members will each pay their own expenses, if any, incurred in connection with the recapitalization.

(q) The Conversion will occur under a plan agreed upon before the transaction is implemented.

(r) Mutual is not under the jurisdiction of a court in a Title 11 or similar case within the meaning of Section 368(a)(3)(A) of the Code.

(s) Following its Conversion into a stock company, Mutual will be treated under State X law as the same corporation that previously existed as a mutual company.

(t) Following the recapitalization and the merger of Mutual and Stock Holding 2, Mutual will continue to own all of the stock of the subsidiaries formerly owned by it and by Stock Holding 2.

With regard to the merger of Mutual and Stock Holding 2, as described above, the taxpayer has made the following representations:

(u) To the best knowledge and belief of the taxpayer and the taxpayer's representatives, the merger of Stock Holding 2 into Mutual will qualify as a reorganization within the meaning of section 368(a)(1)(A).

Based solely on the information submitted and the representations made, we hold that:

(1) Provided that the requirements of section 332(b) are met, no gain or loss will be recognized by Mutual upon the receipt of the assets and liabilities of Stock Holding 1 distributed in complete liquidation (section 332(a)).

(2) No gain or loss will be recognized by Stock Holding 1 on the distribution of its assets to, or the assumption of its liabilities by, Mutual (section 336(d)(3), 337(a), and 337(b)).

(3) Mutual basis in each asset to be received from Stock Holding 1 as a result of the complete liquidation will equal the basis of that asset in the hands of Stock Holding 1 immediately before the complete liquidation (section 334(b)(1)).

(4) Mutual holding period in each asset to be received from Stock Holding 1 as a result of the complete liquidation will include the period during which that asset was held by Stock Holding 1 (section 1223(2)).

(5) Mutual will succeed to and take into account the items of Stock Holding 1 described in section 381(c), subject to the conditions and limitations specified in sections 381, 382, 383, and 384 and the regulations thereunder (sections 381(a) and 1.381(a)-1).

(6) Except to the extent Stock Holding 1's earnings and profits are reflected in Mutual earnings and profits, Mutual will succeed to and take into account the earnings and profits, or deficit in earnings and

profits, of Stock Holding 1 as of the date of the liquidation (sections 381(c)(2)(A), 1.381(c)(2)-1, and 1.1502-33(a)(2)). Any deficit in the earnings and profits of Stock Holding 1 or Mutual will be used only to offset earnings and profits accumulated after the date of the liquidation (section 381(c)(2)(B)).

(7) The Conversion of Mutual from a mutual insurance company to a stock company, as described above, will constitute a recapitalization and, therefore, qualify as a reorganization within the meaning of section 368(a)(1)(E) of the Code. Mutual will be "a party to a reorganization" within the meaning of section 368(b) of the Code.

(8) No gain or loss will be recognized by Mutual members on the exchange of their membership interests solely for Mutual stock, as described above (section 354(a)(1)).

(9) The basis of Mutual membership interests is zero (Rev. Rul. 71-233, 1971-1 C.B. 113; Rev. Rul. 74-277, 1974-1 C.B. 88). The basis of the Mutual stock to be received in exchange for Mutual membership interests will equal the basis of the Mutual membership interests surrendered therefor (i.e., zero) (section 358(a)(1)).

(10) The holding period of the Mutual stock to be received by Mutual members will include the period the Mutual member held such Mutual membership interest surrendered in exchange therefor (section 1223(1)).

(11) Gain will be recognized by those Eligible Members who receive cash in addition to Mutual common stock, as described above, in exchange for their Mutual membership interest, but not in excess of the amount of cash received (section 356(a)(1)). No loss will be recognized on the exchange (section 356(c)).

(12) The redemption of the membership interests in Mutual will be treated as a distribution in partial or full payment in exchange for stock under section 302(a). For the purposes of determining gain in such redemption, the basis of the equity interests deemed to have been redeemed will be zero.

(13) No gain or loss will be recognized by Mutual on the issuance of Mutual stock in exchange for Mutual membership interests (section 1032(a)).

(14) The affiliated group of which Mutual was the common parent immediately before the proposed transaction will remain in existence and Mutual will continue as the common parent (section 1.1502-

75(d)(1)).

(15) The Conversion will not have any effect on the date that any member's life insurance or annuity contract was issued, purchased, or entered into for purposes of sections 72(e)(4), 72(e)(5), 72(e)(10), 72(e)(11), 72(q), 72(s), 72(u), 72(v), 101(f), 264(a)(1), 264(a)(3), 264(a)(4), 264(f), 7702, 7702A, and 7702B. Moreover, the Conversion will not require retesting or the start of new test periods for the contracts under section 264(d)(1), 7702(f)(7)(B)-(E) or 7702A(c).

Section 403(b)(1) of the Code provides, generally, that amounts contributed by certain tax-exempt employers to an annuity contract purchased from an insurance company by such an employer for an employee shall be excluded from the gross income of the employee for the taxable year of contribution and that the amount actually distributed to any distributee under such a contract shall be taxable to such distributee in the year distributed under section 72. Section 403(b)(2) imposes a limit on the maximum amount which may be contributed to a tax-sheltered annuity described in section 403(b) on behalf of an employee in any taxable year. Section 403(b)(11) provides that the provisions of section 403(b)(1) will not apply to an annuity unless, under the annuity, distributions are restricted to certain "distribution events" such as separation from service or attainment of age 59 & ½ .

Section 408(b) of the Code defines an IRA annuity as an annuity or endowment contract which is issued by an insurance company and which meets the requirements of section 408(b). Section 408(b)(2) establishes the annual limit on contributions and premiums to an IRA. Section 408(d)(1) provides that amounts paid or distributed from an IRA shall be included in gross income by the payee or distributee in the manner provided in section 72.

Section 72(a) of the Code generally provides that gross income includes any amount received as an annuity under an annuity, endowment, or life insurance contract. Section 72(e)(2) provides that any amount which is received under an annuity, endowment or life insurance contract and is not received as an annuity, (i) if received on or after the annuity starting date, shall be included in gross income, and (ii) if received before the annuity starting date, shall be included in gross income to the extent allocable to income on the contract and shall not be included in gross income to the extent allocable to the investment in the contract. Section 72(c)(4) defines the annuity starting date, in part, as the first day of the first period for which an amount is received as an annuity under the annuity contract. Section 72(e)(3) provides that an amount shall be treated as allocable to income on the contract to the extent that such amount does not exceed the excess of the cash value of the contract immediately before the amount is received, over the investment in the contract at the time. Section 72(e)(5) provides, in part, that, with certain exceptions, an amount received from a trust described in section 401(a), which is exempt from tax under section 501(a), or from a contract purchased by a trust described in section 401(a), purchased as part of a plan described in section 403(a) or from a contract under section 403(b), that the proceeds shall be included in gross income, but only to the extent it exceeds the investment in the contract. Section 72(e)(6) provides that the investment in the contract, as of any date, is the aggregate amount of premiums or other consideration paid for the contract before such date, minus the aggregate amount received under the contract before such date to the extent such amount was excludable from gross income.

Section 72(t) of the Code provides, in part, that, if any taxpayer receives any amount from a qualified retirement plan (defined in section 4974(c) as including annuity contracts under sections 401(a), 403(a), 403(b), and 408(b)) prior to certain dates or the occurrence of certain events specified in section 72(t)(2) the taxpayer's tax for the taxable year shall be increased by an amount equal to 10 percent of the portion of such amount which is includible in gross income.

Section 4973 of the Code imposes an excise tax equal to 6 percent of the amount of any excess contribution to an IRA or section 403(b) annuity. This 6 percent tax applies for each taxable year during which such excess contributions remain in such IRA or section 403(b) annuity, determined as of the end of the taxable year.

Section 4979 of the Code imposes an excise tax equal to 10 percent of the excess aggregate contributions under a qualified plan or section 403(b) tax-sheltered annuity plan for a taxable year. Excess aggregate contributions under section 4979 are defined, in part, as the sum of the employer matching contributions and employee contributions, actually made, on behalf of highly compensated employees for a plan year in excess of the maximum amount of such contributions permitted under the actual contribution percentage test of section 401(m)(2) for such plan year.

Section 3405 of the Code requires the payor of a "designated distribution," within the meaning of section 3405(e)(1), to withhold certain amounts from such distributions. In general, absent an election under section 3405(b)(2) made by a recipient, section 3405 requires the payor to withhold on distributions from employer deferred compensation plans, IRAs, and commercial annuities.

As a general rule, all interest, dividends, capital growth, stock distributions or any other change in the nature of assets, through reorganization, recapitalization or otherwise, are held as part of the tax-deferred solution, i.e., the TSA, the IRA and the qualified plans, until the assets are distributed. Only upon distribution are such increases in account value taxable to the recipient. Central to our analysis of your submitted ruling requests is the question of whether or not membership interests in a mutual insurance company are within the stated plans.

In this regard, any membership interests in a mutual insurance company which arise from the purchase of an insurance contract are inextricably tied to the contract from the time of purchase. These membership interests are created by operation of state law solely as a result of the policyholder's acquisition of the underlying contract from a mutual insurance company and cannot be transferred separately from that contract. Prior to conversion, the membership interests have no determinable value apart from the insurance contract itself. Further, if the insurance contract is surrendered by the policyholder or, in the event an insurance contract is terminated by payment of benefits to the contract beneficiary, these membership interests cease to exist, having no continuing value. The membership rights associated with the tax qualified retirement contracts, are acquired as a direct result of tax-favored payments to a mutual insurance company. Indeed, these membership interests cannot be obtained by any purchase separate from an insurance contract issued by Mutual In view of the foregoing, such interests are part of the tax qualified retirement contracts, created pursuant to sections 401(a), 403(b), and 408(b) of the Code respectively.

While it has been recognized that consideration received in a demutualization transaction is in exchange for a membership interest in a mutual insurance company, and not from or under an insurance contract, such a distinction does not require the detachment of such consideration from the tax qualified retirement contracts, which consists of both the contracts and all other interests which arise with the purchase of such a contract. See, Revenue Ruling 71-233, 1971-1 C.B. 113. Rather, contracts and the related membership interests must be viewed as part of a program of "interrelated contributions and benefits" which are retained within the plans. Cf., Income Tax Regulation section 1.72-2(a)(3)(i).

The planned issuance of policy credits does not constitute a distribution of such credits to the annuitants. The conversion of membership interests in Mutual to policy credits, is a mere change in form of one element within the arrangement to another. Since the conversion increases the accumulation value of the annuity contracts, the policy credits are treated, for purposes of sections 403(b)(11) and 408(b)(3) of the Code, in the same manner as any other return of, or return on, an investment within the arrangements described above, and are not regarded as having been received by the policyholder.

Similarly, under sections 402(a), 403(b)(1) and 408(d) of the Code, only amounts paid or distributed under the applicable plans, will be included in the gross income of the distributee under the rules of section 72. Section 72(e), dealing with the tax treatment of amounts not received as an annuity, provides for the inclusion of such amounts when received by the distributee. As policy credits will be issued in exchange for membership interests, such interests being held within the applicable plans, no amount is treated as received by, or includible in, the gross income of any policyholder, under such plans, of Mutual For purposes of section 72(e)(3), the value of policy credits which will be added to the tax-qualified retirement contracts will not be regarded as part of the investment in the contracts, an amount which under section 72(e)(6) consists of the aggregate amount of premiums or other consideration paid for the contract. In addition, as no amount is to be treated as having been distributed as a result of the issuance of policy credits, nor received by the tax-qualified retirement policyholders outside the plans, the additional 10 percent tax imposed by section 72(t) does not apply.

As indicated above, section 4979 of the Code imposes excise taxes on certain excess contributions made to plans described in sections 401(a) and 403(b). Section 4973 imposes excise taxes on certain excess contributions made to IRAs and to certain tax-sheltered annuity plans described in section 403(b). Because the addition of policy credits pursuant to the conversion occurs within the above arrangements, causing neither a distribution from, nor a contribution to, such annuities, no excess contributions can be attributed to the addition of policy credits to the pension annuities.

Section 3405(b) of the Code requires a payor to withhold income taxes on certain "designated distributions," including distributions from or under an employer deferred compensation plan, an individual retirement plan or a commercial annuity. The addition of policy credits within the tax-sheltered annuity arrangement described in section 403(b) or IRA arrangement pursuant to the conversion, does not result in the distribution of any amounts to individual policyholders, within the meaning of section 3405(e)(1)(A), and will not be subject to any requirement to withhold.

Accordingly, we conclude that under the terms of the proposed demutualization transaction, whereby Mutual plans to issue policy credits to Qualified Contracts, that:

(16) The issuance of policy credits to Mutual members owning Qualified Contracts –

(1) Will not be treated as a distribution that would affect the treatment of the Qualified Contracts under sections 402, 403(b) or 408;

(2) Will not be treated as a distribution or contribution with respect to the Qualified Contracts that would result in an additional income or excise tax under sections 72(e), 72(t), 4973, or 4979;

(3) Will not result in current taxable income to the members owning the Qualified Contracts;

(4) Will not be treated for purposes of section 72 as part of the investment in the Qualified Contracts, but will be treated for purposes of sections 403(b) and 408 as investment earnings attributable to the year in which the policy credits are issued; and

(5) Will not be subject to withholding pursuant to section 3405.

The rulings provided herein are based upon the assumption that the plans described are tax-sheltered annuity plans that meet the requirements of section 403(b), IRA’s that meet the requirements of section 408(b), or plans that meet the requirements of section 401(a).

The rulings contained in this letter are based upon information and representations submitted by the taxpayer and accompanied by a penalty of perjury statement executed by an appropriate party. While this office has not verified any of the material submitted in support of the ruling request, verification of the factual information and other data may be required as part of the audit process.

No opinion is expressed as to the tax treatment of the transactions under other provisions of the Code or Income Tax Regulations or as to the tax treatment of any conditions existing at the time of, or effects resulting from, the transaction that are not specifically covered by the above rulings.

Our ruling that the Conversion constitutes a reorganization within the meaning of section 368(a)(1)(E) of the Code is conditioned on Mutual being considered the same entity before and afer the Conversion under State X law.

This ruling is directed only to the taxpayer(s) requesting it. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

A copy of this letter should be attached to the federal income tax return of Mutual and Stock Holding 2 for the taxable year in which the transaction covered by this ruling letter is consummated.

Sincerely,
Associate Chief Counsel (Corporate)
By: Lewis K Brickates
Assistant to the Branch Chief, Branch 2