INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM
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Attention: Chief, Appeals Office

Taxpayer's Name:

Taxpayer's Address:

Taxpayer's Identification No:
Years Involved:
Date of Conference:

LEGEND:

Taxpayer =

State X =

Year 1 =

Year 2 =

Year 3 =

Year 4 =

Date 5	=
Guaranty Fund	=
x	=
y	=
z	=
m	=
o	=
p	=
q	=
r	=
Court A	=
Plan	=

Policyholder Group =

ISSUE:

Whether the Taxpayer's distributions of surplus to certain of its policyholders, as part of a state mandated plan in which Taxpayer became the successor life insurance company to a Number of insurance departments ("LIDs"), constitute deductible policyholder dividends under I.R.C. section 808, or instead nondeductible expenditures in a capital transaction in which the policyholders exchanged an ownership interest in their respective LIDs for the distributions of surplus?

CONCLUSION:

We conclude that the payments constitute expenditures in a capital transaction, and therefore are not deductible under section 808.

FACTS:

Background

In Year 1, State X authorized to sell life insurance. The was designed to provide low cost life insurance for wage earners.

Under the original , each was authorized to establish its own LID. The LID was liable for the payment and satisfaction of liabilities pertaining to the insurance business only. The could apportion its expenses between the LID and the other business but none of the surplus of the insurance business could ever inure to the The principal benefit to the bank in establishing a LID was the ability to sell a popular financial product to its customers.

Initially, only were permitted to establish LIDs. In Year 2, the State X legislature amended the law to permit with LIDs to . By Date 5 (the time of the transaction described below), fewer than half of the which had LIDs were still

While the LIDs were subject to applicable provisions of the life insurance laws, those departments did not enjoy all the rights and privileges of commercial life insurance companies and were subject to different licensing and operational requirements. Additionally, the LIDs were subject to extensive control by the State.

Specifically, the LIDs were subject to control and oversight by two entities, Guaranty Fund and the State X actuary.

Guaranty Fund was created for the purposes of intervening and protecting the policyholders in the event of an insolvent liquidation of a LID. In practice, however, Guaranty Fund exercised broad powers of regulation. For example, if one of the LIDs suffered particularly poor claims experience, with the result that its surplus dropped below certain specified levels, Guaranty Fund had the authority to mandate another LID with more favorable experience to transfer its surplus to the LID with the lower surplus. Guaranty Fund also appointed the State X actuary.

Under State X law, the LIDs were required to maintain a surplus. The amount of that surplus was to remain between p percent and q percent of net reserves. If the surplus increased above q percent of net reserves, approval of the State X actuary was required. The State X actuary, however, routinely approved of surplus levels of LIDs above q percent. While State X law required the to distribute the net profits from the LIDs to their policyholders not accumulated to surplus, nothing in State X law explicitly provided that either the policyholders or the banks would ever be entitled to any amount of the LID's accumulated surplus.

The policyholders did not have voting rights in the LIDs and the State X law did not specifically provide for any liquidation rights. Until Year 3, State X law provided that in the event of a liquidation of a LID, the policies were assumed by, and the surplus was received by, Guaranty Fund. In Year 3, the law was amended to provide that when a LID liquidated, the surplus, along with the policies, would be assumed either by a successor or by Guaranty Fund, or by a commercial mutual insurance company that fit certain business criteria. The Taxpayer informs us, however, that the provision allowing a mutual insurer to receive the surplus and assume the policies was meaningless, because no mutual insurer which operated in State X since the inception of the system has ever met the required business criteria.

State X law, in effect at the time of the transaction described herein, provided that if a converted to a its eligible account holders and supplemental eligible account holders were entitled to preemptive rights to acquire stock in the The SBLI policyholders, however, did not have such rights.

The Aggregation

In Year 4, after considerable deliberation, the State X legislature enacted legislation to restructure the system. The restructuring was to be accomplished pursuant to a written plan (the "Plan"). State X established Taxpayer as a domestic stock life insurance company authorized to issue insurance contracts and to assume

the ownership and operation of the LIDs. The Taxpayer assumed all of the contracts and outstanding policies of the former LIDs of the Each of the was issued one share of voting stock in Taxpayer and nonvoting stock in Taxpayer in proportion to the surplus they contributed to the insurance company. After the transaction ("the Aggregation"), the continued to sell SBLI, but only as agent for a single insurer, Taxpayer. The Plan became effective on Date 5.

As part of the Plan, the policyholders who held policies on Date 5 were to be entitled to a series of "special distributions." The Plan for Taxpayer's formation provided for distributions to individual policyholders of an amount equal to the total aggregated surplus of all of the LIDs, or $x. However, the total aggregated surplus was to be paid over a y to z year period (or perhaps longer), with the payment of only one year of interest. The Plan indicated that providing for the payment over the extended period was designed to deliver m percent of the present value of the combined surplus of the LIDs of the to the policyholders. The addition of a single year of interest raised the total payment, on a present value basis, to approximately o percent of the present value of the combined surplus of the LIDs.

In determining the amount of the surplus, the Plan used a formula that would apply in State X to a mutual company converting to a stock insurer. In a demutualization under State X law, the law provides that the surplus to be distributed is determined upon the insurer's entire surplus as shown on their financial statements most recently filed with the State X commissioner of insurance. Intangible assets are not considered in the calculation. The same methodology was used in determining the $x of surplus available for the special distributions.

The Plan provides that only policyholders on the date of the transaction (i.e., Date 5) are eligible for the special distributions. If a policyholder's insurance lapses, he becomes ineligible for the special distributions. However, if the policyholder dies prior to completion of the special distributions, his beneficiary, in addition to the death benefit, receives an additional payment equal to the present value of all future special distributions. Further, if Taxpayer were liquidated prior to the completion of the payments, the policyholders would receive an amount equal to the present value of the difference between the surplus assumed by the Taxpayer and the sum of previously distributed special distributions.

Additionally, payment of the special distributions is contingent upon future favorable experience. If the surplus of Taxpayer would ever fall below p percent of net reserves, Taxpayer would suspend payment of the special distributions until the surplus was again above p percent.

The Plan noted that payment of the special distributions recognized the policyholder contributions to the growth and development of the system. The Plan also indicated the method of payment of special distributions was designed to assure that as special distributions were made, Taxpayer would not be left without adequate capital. The Financial Projections portion of the Plan indicated the special distributions were expected to be funded out of current earnings.

Currently, all new policies are issued by the Taxpayer. Under State X law, the policyholders have a right to participate in the profits of the Taxpayer. The Taxpayer has had favorable experience, and has paid the special distributions on a regular basis. We have been informed that in fact the surplus of Taxpayer has not been below q percent since Date 5.

Prior to the Aggregation, the did not include the value of the LIDs on their balance sheets. After the Aggregation, the now include the value of their Taxpayer stock on their financial statements as an asset of the bank.

However, the stock held by the has restricted rights. In the life insurance statutes amended in connection with the Aggregation, Policyholder Group was created. Policyholder Group must approve all payments of stockholder dividends. Since the Aggregation, the banks have received dividends of r percent each year.

Under the Aggregation legislation, in the event of a solvent liquidation, eligible policyholders would receive the unpaid portion of their special distributions. All remaining surplus would be apportioned between the policyholders and the banks on an equitable basis.

The Court A Opinion

Prior to enactment of the Plan, the State X legislature certified to Court A (the highest court in State X) certain questions concerning whether the proposed Aggregation violated either the Federal Constitution or the State X Constitution. One question addressed whether the proposed aggregation deprived the policyholders of property without due process of law.

Court A found that while the assets, net profits, and surplus of the LIDs are "devoted exclusively to the benefit of the policyholders," the proposed Aggregation did not deprive the policyholders of property without due process of law. The court indicated that it was unclear whether the policyholders had an interest in the LIDs, although they did note longstanding precedent in State X indicating that a mutual policyholder had no right to demand a particular dividend. In any case, the court pointed out, the policyholders were being paid the special distributions. The court

indicated that the payment of the special distributions made it more comfortable that the policyholders were not deprived of property without due process of law.

Court A concluded that the transaction did not impair the policyholders' contract or ownership rights in the LIDs. Since the policies had provisions for the assignment of the policies, the court held, the policyholders could not have any reasonable expectation that there would be no substitution of another entity for their particular The court found that the change from several LIDs to a single entity would not impair the prospects that the policyholders would receive what they were due under the contract.

LAW AND ANALYSIS:

Life insurance companies are subject to tax under Part I of Subchapter L of the Internal Revenue Code. Additionally, life insurance companies, as corporations defined in I.R.C. section 7701(a)(3), are subject to the general principles of subchapter C of the Code, unless specifically overruled by the rules of subchapter L.

Section 801(a) imposes a tax on life insurance companies, based on life insurance company taxable income. Section 801(b) defines life insurance company taxable income as life insurance gross income minus life insurance deductions.

Under section 804, life insurance deductions include the general deductions provided in section 805. One such general deduction is the deduction for policyholder dividends. Section 808(a) provides that, for purposes of Part I of Subchapter L, the term "policyholder dividend" means any dividend or similar distribution to policyholders in their capacity as such. Under section 808(b)(1), the term "policyholder dividend" includes any amount paid or credited where the amount is not fixed in the contract but depends on the experience of the company or the discretion of management.

The payments at issue in this case were not fixed in the contract, but depended on the experience of the company. The Taxpayer's payments were made pursuant to the Plan, and were not provided for in the policies it issued. The Plan also provided that the payment of the special distributions by Taxpayer over a period of years was contingent on Taxpayer's surplus remaining at a level equal to at least p% of reserves. Since the level of Taxpayer's surplus depends upon Taxpayer's own experience, the amount and timing of the payments at issue depended on both the experience of the LIDs before the Aggregation, and the experience of Taxpayer after the Aggregation.

However, we still must consider whether the policyholders had an ownership interest in their respective LIDs and, if so, whether they exchanged that interest for the special distributions. If they did, the special distributions are not policyholder dividends.

The UNUM Case

In *UNUM v. United States*, 130 F.3d 501 (1st Cir. 1997), *cert. denied* 119 S. Ct. 42 (1998), the First Circuit held that distributions made by a mutual life insurance company to its policyholders in connection with a demutualization are not deductible.

In *UNUM,* a holding company was formed to own all the stock of a new stock company. On the date of the consummation of the transaction, all policyholders of the mutual company transferred their mutual interests to the stock insurance company in exchange for stock in the holding company. Certain policyholders (generally those with smaller mutual interests) were eligible immediately to exchange their holding company stock for cash. Other policyholders retained a stock interest in the holding company. *UNUM* at 504. The company also created a Participation Fund Account (PFA), also known as a "closed block," in connection with the reorganization. The closed block consisted of assets set aside exclusively for those policyholders prior to the conversion. The purpose of the closed block was to ensure that the expectation of future policyholder dividends would not be impaired by the shareholders or management of the converted stock company. *Id.* at 505.

The Taxpayer claimed that the payments to the policyholders of cash and holding company stock in connection with the demutualization were deductible as policyholder dividends under section 808. The Commissioner disallowed this claim, and the District Court and First Circuit upheld the Commissioner's determination.

The First Circuit agreed with the Service that the term "policyholder dividends" does not include a "value-for-value" exchange that occurs during a capital transaction. *Id.* at 510. The courts found that the phrase "in the [policyholders'] capacity as such" in section 808 requires that the dividend distributions be based upon the *contractual* relationship between policyholder and insurer. Here, the payment that the policyholders received was based *not upon their contractual relationship, but in exchange for the mutual holders' equity* interest in the corporation. *Id.* at 513.

The court decided that subchapter L had no application to this capital transaction and looked to general principles of subchapter C to determine the tax consequences of the cash and stock payments. The policyholders who received cash essentially redeemed the equity interests inherent in their mutual policies in exchange for cash. Thus, in this "classic redemption," section 311 applied to disallow any deduction on the payment by UNUM. Section 311 generally holds that gain but not loss is recognized to

a corporation on a distribution (not in complete liquidation) with respect to its stock. *Id.* at 511.

The court also held that section 1032 applied to disallow any loss on the distribution of stock to the policyholders. Under this section, a corporation may claim no gain or loss on the issuance of its own stock in exchange for property. Here, UNUM had issued its stock to the policyholders in exchange for the equity held by the policyholders by virtue of their mutual policies. *Id.* at 512.

The Taxpayer's Arguments that UNUM is Distinguishable from the Instant Case

The Taxpayer in the instant case argues that the holding in *UNUM* has no application to this case because the demutualization transaction in *UNUM* is very different from the Aggregation transaction which formed Taxpayer. First, the Taxpayer argues, the policyholders of the Taxpayer did not have any ownership rights in the LIDs prior to the Aggregation. Thus, the special distributions *cannot* be in exchange for the ownership rights of the policyholders, because the policyholder had no ownership rights to surrender. Secondly, unlike *UNUM*, where the policyholders unquestionably surrendered rights in the demutualization, the Taxpayer's policyholders had no significant change in their economic rights before and after the transaction. Without this change in the relative economic rights of the policyholders before and after the Aggregation, the Taxpayer concludes that the special distributions falls well within the definition of a policyholder dividend.

The Taxpayer argues that ownership in a mutual entity can only be measured by indicia of ownership. To that end, it examines three of the traditional indicia of ownership in a mutual company--voting/control rights, liquidation rights, and rights to profits of the company.

1. Voting Rights/Control

It is not disputed that policyholders who owned prior to the Aggregation had no voting rights or equivalent type of control over the LIDs. Rather, the program was subject to extensive regulation by the State X government, through the Guaranty Fund and the State X actuary. It was State X and its agencies, and to a lesser degree the that made investment decisions and determined reserve levels, dividend payout, and the amount retained in surplus. If the policyholders disagreed with the decisions of State X or the they were given no recourse to vote to change the policies of the LIDs.

In fact, the Taxpayer argues that after the Aggregation, the policyholders have more control of the Taxpayer than they did of the LIDs. The Policyholder Group, which

is largely comprising policyholders and is charged to act in the policyholders' interest, elects one of the Board of Directors of the Taxpayer and must approve major corporate decisions, including the decision to pay shareholder dividends.

2. Liquidation Rights

The Taxpayer asserts the policyholders had no liquidation rights in the LIDs. In fact, it appears no statutory provision existed providing for the total elimination and liquidation of the program. The State X law prior to the Aggregation provides for who would be eligible to assume the policies in the event of the solvent or insolvent termination of an individual LID. In the Taxpayer's view, if the entire program had been eliminated, State X would have decided how to distribute the surplus, and may have decided to use the surplus for the benefit of the policyholders. However, there was no State X statute indicating that the policyholders had a right to the surplus. Although the Court A Opinion clearly indicates that the surplus was devoted exclusively to the benefit of the policyholders, it would still have required an action by State X for the policyholders to receive the liquidation proceeds. Thus, again, it was the State, and not the policyholders, who exercised control over the surplus.

The Taxpayer argues that after the Aggregation, the policyholders have liquidation rights in Taxpayer greater than they did in the LIDs. If State X were to decide to liquidate Taxpayer, State X law now provides that State X would allocate the surplus between the policyholders and the banks.

3. Rights to Profit

Finally, Taxpayer claims, a typical mutual policyholder has an *exclusive* right to the profits of the mutual entity. By contrast, the policyholders who owned had a participating life insurance policy prior to the Aggregation, and they have a participating policy after the Aggregation. By virtue of their having a participating policy, Taxpayer asserts, they have a *customer* right to share in profits now, just as they did before the Aggregation. This right, however, has never risen to the level of an ownership right.

According to Taxpayer, that this is the case is borne out by the fact that, unlike *UNUM*, there was no closed block set up during the Aggregation to "wall off" assets specifically for benefit of the old policyholders. The closed block is set up to protect those policyholders that lose rights. Here, the policyholders have the same rights after the Aggregation as before. Thus, it would be unnecessary, and even inappropriate, to segregate assets dedicated to those policies written before the Aggregation from the working assets of the company. Moreover, since the Policyholder Group must still approve all shareholder dividends and major corporate decisions, they can now in some

manner participate in determining the amount distributed out of the earnings of the Taxpayer after the Aggregation.

In sum, the Taxpayer concludes, all indicia of ownership which resided with the policyholders of UNUM--rights to control the entity, rights in liquidation, and rights to profit, did not reside with the policyholders prior to the Aggregation. In point of fact, State X controlled the LIDs and the surplus held by them. While State X regulated the LIDs for the benefit of the policyholders, it was State X and its Agencies, and not the policyholders, who possessed the requisite rights of ownership and should be considered the closest to the "owners" of the LIDs.

The Taxpayer maintains that the special distributions were essentially unrelated to the Aggregation. Rather, the Taxpayer argues, the special distributions were the result of excessive conservatism of the State X actuary. The Taxpayer provided a report from an actuary which indicated that the aggregate surplus levels of all of the LIDs at the time of the Aggregation were considerably higher than contemplated under the statute. It has indicated that even in the absence of the Aggregation, the special distributions likely would have been made anyway, to return the excessive surplus held by the Taxpayer to the shareholders. Finally, the Taxpayer argues that the special distributions constitute a mere return of excess surplus is confirmed by two facts about the distributions: (1) policyholders whose policies lapse do not continue to receive the special distributions, and (2) payments of the special distributions do not continue to be made in the event the surplus falls below p percent.

The Special Distribution Constitutes a Part of a Capital Transaction

Although Taxpayer raises a strong argument why the facts of this case are different from that of the *UNUM* case, ultimately we conclude that the special distributions were an integral part of a capital transaction and, therefore, are not deductible policyholder dividends. Payment of the special distributions was made to policyholders only *as of the date of the Aggregation* over a period of many years. Policyholders whose policies were written after the Aggregation have no right to the payment. This fact renders the Taxpayer's statement that the special distributions were unrelated to the Aggregation less tenable, and a mere return of excess surplus. Rather, it leads to the conclusion that the Aggregation and the payment of the special distributions are part of a single transaction.

The language contained in the Plan for the Aggregation casts doubt on the Taxpayer's argument that the special distributions were designed to disgorge the Taxpayer of excess surplus created as a result of the conservatism of the State X actuary. The Plan never addresses the issue of return of excess surplus as the reason for the special distributions.

We have concluded that each LID, in material respects, may be characterized as the functional equivalent of a mutual life insurance company. By definition, a mutual life insurance company differs from a stock life insurance company in that a mutual life company does not have stockholders. *See, e.g., Pan American Life Insurance Company v. United States*, 97-2 U.S.T.C. ¶ 50,655 (E.D. La. 1997). The LIDs did not have stockholders with a superior right of ownership in the underlying assets of the LIDs. While the policyholders may have had limited rights under the old system, no other party had a *better* claim to ownership of the LIDs than the policyholders.

Further, the Aggregation and the special distributions resemble the payment that would be made in the standard demutualization of a mutual life company into a stock company. The total payment for the special distributions was determined by reference to the entire surplus of the LIDs . The Plan used a formula that would apply in State X to a mutual insurance company converting to a stock life insurance company.

We do not dispute the Taxpayer's claim that the policyholders did not have voting rights. Nor do we dispute that State X and its Agencies had significant control and discretion over the funds of the surplus. However, policyholders have been found to have an interest in an insurance company because the corporate charter indicated that the surplus belonged to them, despite their having no voting rights in the company, no right to demand the surplus, and no other right to control the insurance company. *Ohio State Life Insurance Company et al. v. Clark*, 274 F.2d 771 (6th Cir. 1960), *cert. denied*, 363 U.S. 828 (1960).

In the instant case, it is clear the policyholders had the strongest claim of any group on the assets of the LIDs, particularly the surpluses of the LIDs. The Court A opinion confirms this point by stating that "The assets of those insurance departments, including the net profits generated and the accumulated surplus, are devoted exclusively to the benefit of the policyholders." The were specifically prohibited by statute from ever succeeding to the assets. State X did exercise control over the LIDs, but it operated the LIDs exclusively for the benefit of the policyholders, and not for its own benefit.

After the Aggregation, by contrast, the assets of the Taxpayer are no longer devoted exclusively to the benefit of the policyholders. On the contrary, the surplus accrues to the benefit of both the and the policyholders. This result was reflected in the payment of shareholder dividends. The now are paid a dividend out of the surplus of the Taxpayer, which would have been prohibited under the old system. Although the shareholder dividend is subject to the approval of the Policyholder Group, it nevertheless depletes the amount of surplus which is held for the policyholders. Regardless of whether or not the dividend predominantly reimburses the banks for their expenses, or whether it has remained constant, it still depletes the

surplus of the Taxpayer, which could not happen under the old system. This lack of exclusivity is also reflected in the statutory liquidation rights, which call for an equitable distribution between policyholders *and the*

Most telling in confirming this point, the now show the value of their stock in Taxpayer as an asset of the bank on their financial statements, while they never showed any of the value of the LIDs on their financial statements prior to the Aggregation. This fact strongly belies the notion that the did not acquire any ownership interest in the Taxpayer in the transaction. Moreover, Court A indicated that they felt more comfortable that the policyholders were not deprived of property in the Aggregation without due process of law *precisely because the policyholders were to receive the special distributions*. This point leads to the inevitable conclusion that when the received an interest in the assets of the LIDs, they received it from the policyholders.

Equally importantly, the now have considerably more power to control the Taxpayer than they did to control the LIDs. The elect all but one of the members of the Board of Directors. Most of the major decisions of the company are made by the Board. Further, since the are now a unified entity, they appear to have more control and more leverage in negotiations with the agencies of State X.

That no closed block was created in connection with the Aggregation does not persuade us that this case is different from *UNUM*. State X created a Policyholder Group specifically for the purpose of safeguarding the rights of the policyholders from overreaching by the new stockholders of Taxpayer (i.e., the banks). These special protections may have rendered the creation of a closed block unnecessary. Additionally, the First Circuit in *UNUM* specifically stated that their holding that the payments were not policyholder dividends would not have been different if UNUM had not created a closed block, because the basic nature of the transaction as a value-for-value exchange would have remained unchanged. *UNUM* at 514, n. 14.

Taking into account all of the concomitant circumstances surrounding the Aggregation transaction and the payment of the special distributions, the policyholders in this case, just as in *UNUM*, surrendered ownership rights in the LIDs in connection with the Aggregation. Moreover, we believe that State X, in providing for the special distributions, compensated them in exchange for their rights. Therefore, the payments cannot be viewed as policyholder dividends.

CAVEAT(S)

A copy of this technical advice memorandum is to be given to the taxpayer(s). Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.