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Department of the Treasury

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Acquiring =

Target =

Sub =

State A =

State B =

State C =

Date 1 =

Year 1 =

Year 2 =

Year 3 =

Segment A =

This is in response to a letter dated November 16, 2000, requesting rulings as to the federal income tax consequences of a proposed transaction. Additional information was submitted in letters dated December 22, 2000, December 27, 2000, January 31, 2001, and March 22, 2000. The information submitted for consideration is summarized below.

Acquiring, a State A corporation, is a mutual life insurance company taxable under Part I of subchapter L of the Internal Revenue Code, and is the parent of a life/nonlife consolidated return group. It uses the accrual method of accounting and files a calendar year tax return. Acquiring's policyholders have the right to vote for directors, to share in distributions of surplus, and to share in the value of assets upon liquidation.

Target, a State B corporation, is a mutual life insurance company taxable under

Part I of subchapter L, and is the parent of a life/nonlife consolidated return group. It uses the accrual method of accounting and files a calendar year tax return. Target's policyholders have the right to vote for directors, to share in distributions of surplus, and to share in the value of assets upon liquidation.

Acquiring and Target operate various lines of insurance businesses, including the Segment A insurance business and other insurance businesses. For what are represented to be valid business purposes, Acquiring proposes to acquire all of Target's assets and liabilities in a statutory merger (the "Merger"). The Merger will take place prior to Date 1 of Year 2. The Target shareholders will not have any right to receive cash in the Merger.

As a result of the Merger, the outstanding policies of Target will become policies of Acquiring by operation of law. Target's former participating policyholders will have the same voting and liquidation rights as other Acquiring policyholders. They will also have the right to share in any distributions of surplus.

Except for Acquiring's assumption of Target's obligations, the Merger will have no effect on the insurance and annuity contracts issued by Target. The contracts will continue in full force and effect, with the same terms and conditions. Except for the Subsequent Transactions, as defined below, Acquiring has no plan or intention to enter into any reinsurance agreements with respect to Target's existing policies and there are no present reinsurance agreements between Acquiring and its affiliates on the one hand and Target and its affiliates on the other.

Acquiring recently acquired all the stock of Sub, a State C corporation, in a transaction that was represented to constitute a qualified stock purchase within the meaning of § 338(d)(3). However, no § 338 election was or will be made with respect to such purchase. Sub is a shell company with licenses to engage in the insurance business in many states. Sub will be merged with and into a State B corporation which will be newly formed and wholly owned by Acquiring (NewSub) for the purpose of changing Sub's domicile from State C to State B. It has been represented that the merger of Sub with and into NewSub will qualify as a reorganization under § 368(a)(1)(F). The transactions in this paragraph, each of which has occurred or will occur before the Merger, will be referred to as the "Prior Transactions."

Immediately following the effective time of the Merger, Acquiring will (1) transfer to NewSub certain investment assets for NewSub's initial capital and surplus, (2) transfer to NewSub, through a coinsurance transaction, all the Segment A insurance business of Acquiring and Target; and (3) transfer to NewSub certain non-investment assets of Target and Acquiring and/or grant to NewSub the unrestricted right to use certain non-investment assets of Target and Acquiring. The transactions in this paragraph will be referred to as the "Subsequent Transactions." Acquiring will retain more than 50% of the Target assets received in the Merger.

The following representations have been made in connection with the Merger:

(a) The Merger will constitute a statutory merger that will qualify as a reorganization under § 368(a)(1)(A), provided that (i) the Acquiring proprietary interests received by the Target policyholders in the Merger are continuing equity interests for purposes of determining whether the continuity of interest requirement of § 1.368-1(b) is satisfied, and (ii) the Subsequent Transactions will not affect the qualification of the Merger as a reorganization under § 368(a)(1)(A).

(b) All terms of the life insurance, annuity, and other insurance contracts issued by Target, including the face values, insurance in force, and borrowing terms, will be the same before and after Acquiring assumes the liabilities with respect to these contracts issued by Target.

(c) Target did not change any of its historic practices regarding the declaration of policyholder dividends in connection with, or in expectation of, the Merger.

(d) In the Merger the Target policyholders will not receive any stock, securities, or other property that is attributable to interest which has accrued on securities on or after the beginning of the policyholder's holding period within the meaning of § 354(a)(2)(B).

(e) Following the transaction, Acquiring will continue the historic business of Target, or use a significant portion of Target's historic business assets in a business.

A. Insurance Issues

Section 381(a) provides that if a corporation acquires the assets of another corporation in a transfer to which § 361 (relating to nonrecognition of gain or loss to corporations) applies, the acquiring corporation succeeds to and takes into account, as of the close of the day of transfer, the items of the transferor corporation described in § 381(c), subject to the conditions and limitations specified in §§ 381(b) and (c). This treatment is allowed only if the transfer is made in connection with a reorganization described in, inter alia, § 368(a)(1)(A).

Section 381(c)(4) requires the acquiring corporation to use the method of accounting used by the transferor corporation on the date of transfer unless different methods were used by several transferor corporations or by a transferor corporation and the acquiring corporation. If different methods were used, the acquiring corporation shall use the method or combination of methods of computing taxable income adopted pursuant to regulations prescribed by the Secretary. See the applicable regulations regarding the carryover of accounting methods.

Section 381(c)(22) provides that if the acquiring corporation is an insurance company taxable under subchapter L, it must take into account those items of the transferor corporation required to be taken into account for purposes of subchapter L (to the extent proper to carry out the purposes of § 381(a) and subchapter L, and under such regulations as may be prescribed by the Secretary).

Section 1.381(c)(22)-1(a) requires the acquiring corporation to take into account the reserves described in former § 810(c) of the Code (now § 807(c)) transferred to it by the transferor corporation as of the close of the date of transfer in accordance with the provisions of § 381(c)(4) and the regulations thereunder.

Section 803(a) provides that for purposes of this part, the term "life insurance gross income" means the sum of the following amounts:

(1) Premiums. --

(A) The gross amount of premiums and other consideration on insurance and annuity contracts, less

(B) return premiums, and premiums and other consideration arising out of indemnity reinsurance.

(2) Decrease in Certain Reserves. -- Each net decrease in reserves which is required by § 807(a) to be taken into account under this paragraph.

(3) Other Amounts. -- All amounts not includible under paragraph (1) or (2) which under this subtitle are includible in gross income.

Section 805(a)(2) provides for a deduction for the net increase in reserves which is required to be taken into account by § 807(b).

Section 807(c) lists certain items, any decrease or increase between the opening and closing balances of which, pursuant to §§ 807(a) or (b), must be taken into account as gross income under § 803(a)(2) or as a deduction under § 805(a)(2), respectively.

Section 808(a) provides that the term "policyholder dividend" means any dividend or similar distribution to policyholders in their capacity as such. Section 808(b) provides that the term "policyholder dividend" includes -

(1) any amount paid or credited (including as an increase in benefits) where the amount is not fixed in the contract but depends on the experience of the company or the discretion of the management,

(2) excess interest,

(3) premium adjustments, and

(4) experience-related refunds.

Section 808(c)(1) provides that except as limited by paragraph (2), the deduction for policyholder dividends for any taxable year shall be an amount equal to the policyholder dividends paid or accrued during the taxable year.

Section 808(c)(2) provides that in the case of a mutual life insurance company, the deduction for policyholder dividends for any taxable year shall be reduced by the amount determined under § 809.

Section 809(a) provides that, in the case of any mutual life insurance company, the amount of the deduction allowed under § 808 shall be reduced (but not below zero) by the differential earnings amount. The differential earnings amount for any taxable year is the amount equal to the product of (1) the mutual life insurance company's average equity base for the taxable year multiplied by (2) the differential earnings rate for the taxable year. Any excess of the differential earnings amount over the amount of the deduction allowable under § 808 for policyholder dividends shall be taken into account as a reduction in the closing balance of reserves under subsections (a) and (b) of § 807.

Section 809(c)(1) provides that the differential earnings rate for the taxable year is the excess of (A) the imputed earnings rate for the taxable year, over (B) the average mutual earnings rate for the second calendar year preceding the calendar year in which the taxable year begins.

Section 809(d) provides that the imputed earnings rate for any taxable year is the amount that bears the same ratio to 16.5 percent as the current stock earnings rate for the taxable year bears to the base period stock earnings rate. The term current stock earnings rate means with respect to any taxable year, the average of the stock earnings rates (determined under § 809(d)(4)) for the 3 calendar years preceding the calendar year in which the taxable year begins.

Section 809(f) provides that, in the case of any mutual life insurance company, if the recomputed differential earnings amount for any taxable year exceeds the differential earnings amount for that taxable year, the excess shall be included in life insurance gross income for the succeeding taxable year. If the differential earnings amount for any taxable year exceeds the recomputed differential earnings amount for that taxable year, the excess shall be allowed as a life insurance deduction for the succeeding taxable year. The recomputed differential earnings amount for any taxable year is an amount calculated in the same manner as the differential earnings amount for that taxable year, except that the average mutual earnings rate for the calendar year in which the taxable year begins is substituted for the average mutual earnings rate for the second calendar year preceding the calendar year in which the taxable year begins.

Section 1.809-9 provides that, for taxable years beginning after December 31, 1986, neither the differential earnings rate nor the recomputed differential earnings rate that is used in computing the recomputed differential earnings amount under § 809(f)(3) may be less than zero. See also, CUNA Mutual Life Insurance Co. v. United States, 169 F.3d 737 (Fed. Cir. 1999); Indianapolis Life Insurance Co. v. United States, 115 F.3d 430 (7th Cir. 1997); American Mutual Life Insurance Co. v. United States, 43 F.3d 1172 (8th Cir. 1994), cert. denied, 516 U.S. 930 (1995).

Section 1.809-10 provides that, for taxable years ending after December 31, 1991, the equity base of a life insurance company includes both the asset valuation reserve and interest maintenance reserve.

Section 811(e) (the successor of § 818(d) of the 1954 Code as in effect on December 31, 1983) provides that if a return of a life insurance company taxable under Part I of subchapter L "is for a period of less than the entire calendar year (referred to . . . as [the] 'short period')," then § 443 shall not apply in respect to such period, but life insurance company taxable income shall be determined, under regulations prescribed by the Secretary, on an annual basis by a ratable daily projection of the appropriate figures for the short period.[1]

Although § 811(e) omits the language of former §§ 818(d)(2) and 818(d)(3), the

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[1] For taxable years beginning before January 1, 1984, former § 818(d) provided as follows:

(d) Short Taxable Years. -- If any return of a corporation made under this part is for a period of less than the entire calendar year . . ., then section 443 shall not apply in respect to such period, but --

(1) the taxable investment income and the gain from operations shall be determined, under regulations prescribed by the Secretary or his delegate, on an annual basis by a ratable daily projection of the appropriate figures for the short period,

(2) that portion of the life insurance company taxable income described in paragraphs (1) and (2) of section 802(b) shall be determined on an annual basis by treating the amounts ascertained under paragraph (1) as the taxable investment income and the gain or loss from operations for the taxable year, and

(3) that portion of the life insurance company taxable income described in paragraphs (1) and (2) of section 802(b) for the short period shall be the amount which bears the same ratio to the amount ascertained under paragraph (2) as the number of days in the short period bears to the number of days in the entire calendar year.

legislative history of § 811(e) indicates that Congress did not intend to change the special rules for short taxable years except to the extent made necessary by the repeal of the multi-phase system for determining life insurance company taxable income. See, 1 Committee on Finance, United States Senate, 98th Cong., 2d Sess., Deficit Reduction Act of 1984: Explanation Approved by the Committee on March 21, 1984, at 557. Because the 1984 Act repealed the multi-phase system of life insurance company taxation, there was no reason for § 811(e) to have language parallel to former § 818(d)(2). As former § 818(d)(3) referred to the "amount ascertained under [former § 818(d)(2)]," the repeal of the multi-phase system also required that the precise language of former § 818(d)(3) not be carried over to § 811(e). Since § 811(e) provides that the annualization shall be done "under regulations to be prescribed by the Secretary," Congress apparently concluded that there was no need for § 811(e) to have language parallel to former § 818(d)(3). Indeed, the purpose of the "no change" statement in the legislative history is to eliminate any inference that the omission of the language of the former provision from § 811(e) results in new rules for short taxable years of life insurance companies.

Accordingly, the omission of the language of former § 818(d)(3) from § 811(e) does not create new short period rules for life insurance companies. Rather, § 811(e) requires that projected life insurance company taxable income (or loss) for the entire calendar year be properly allocated to the short period based on same ratio as the number of days in the short period bears to the number of days in the entire calendar year. See § 1.818-5(c)(5) (life insurance company taxable income for the short period shall be the amount which bears the same ratio to the annualized amount as the number of days in the short period bears to the number of days in the entire calendar year). See also, H.R. Rep. 432, Part 2, 98th Cong., 2d Sess., 1401 (1984); 1 Committee on Finance, supra, at 524 (Congress intended that the regulations under pre-1984 law serve as an interpretative guide to those provisions of the Deficit Reduction Act of 1984 which are based on pre-1984 law).

Section 809(f)(4) provides as follows:

> (4) SPECIAL RULE WHERE COMPANY CEASES TO BE MUTUAL LIFE INSURANCE COMPANY -- Except as provided in section 381(c)(22), if --
>
> (A) a life insurance company is a mutual life insurance company for any taxable year,
>
> (B) such life insurance company is not a mutual life insurance company for the succeeding taxable year,
>
> any adjustment under paragraph (1) or (2) by reason of the recomputed differential earnings amount for the first of such taxable years shall be taken into account for the first of such taxable years.

The recomputed amount under § 809(f) is a tax attribute that carries over in a transaction subject to § 381(c)(22). The § 809(f)(4) carve-out of transactions subject to § 381(c)(22) indicates that those transactions should be accorded different treatment. Thus, the recomputations under § 809(f)(1) and (2) shall be accounted for in the succeeding taxable year by the acquiring corporation in a transaction subject to § 381(c)(22).

Section 848(a) provides that insurance companies must capitalize "specified policy acquisition expenses."

In lieu of identifying the categories of expenses that must be capitalized, § 848(c)(1) requires that a company capitalize so much of the general deductions for the taxable year as do not exceed specified percentages of net premiums with respect to three different types of insurance contracts ("specified insurance contracts") described in § 848(e).

Section 848(d)(1) provides that, with respect to each category of specified insurance contracts, net premiums equal the excess, if any, of the gross amount of premiums and other consideration for the contracts, over the sum of return premiums and premiums incurred for the reinsurance of the contracts.

B. Employee Plan Issues

Section 401(a) provides that a trust created or organized in the United States and forming part of a stock bonus, pension, or profit-sharing plan of an employer for the exclusive benefit of his employees or their beneficiaries shall constitute a qualified trust if all of the applicable requirements of this section are met.

Section 403(a) provides that if an annuity contract is purchased by an employer for an employee under a plan which meets the requirements of § 404(a)(2) (whether or not the employer deducts the amounts paid for the contract under such section), the amount actually distributed to any distributee under the contract shall be taxable to the distributee (in the year in which so distributed) under § 72.

Section 403(b) provides that if an annuity contract is purchased for an employee by certain tax-exempt employers, or for an employee who performs services for an educational organization by an employer as described in § 403(b), and if certain other requirements are met, then amounts contributed by such employer for such annuity contracts on or after such rights become nonforfeitable shall be excluded from the gross income of the employee for the taxable year to the extent that the aggregate of such amounts does not exceed the exclusion allowance for such taxable year.

Section 408 provides requirements that an individual retirement account and individual retirement annuity issued by an insurance company must satisfy for the tax treatment of § 408 to apply.

In general, the merger of two insurance companies that does not affect the terms or conditions of annuity and insurance contracts issued by the non-surviving company will not cause a change in the treatment of such contracts under §§ 401(a), 403(a), 403(b), or 408, if all applicable requirements of those sections are otherwise met.

C. Rulings

Provided that the merger qualifies as reorganization under § 368(a)(1)(A), and based solely on the information and representations provided, we hold as follows:

(1) For the first tax year ending after the date of transfer, pursuant to the reorganization, (i) Acquiring will include in its reserves at the beginning of such year, for purposes of §§ 807(a) and (b), the ending balances of the reserves described in § 807(c) that Target held immediately before the transfer, and (ii) Acquiring will not take into premium income under § 803(a)(1) any amount with respect to the Target assets transferred to Acquiring in connection with the Merger.

(2) For the tax year ending on the close of the date of transfer (within the meaning of § 1.381(b)-1(b)), pursuant to the reorganization, (i) Target will include in its reserves as of the close of such year, for purposes of §§ 807(a) and (b), the ending balances of the reserves described in § 807(c) that Target held immediately before the transfer, and (ii) Target will not be entitled to a deduction under § 805(a)(6) for transferring assets to Acquiring as consideration for the assumption by Acquiring of liabilities under Target's annuity and insurance contracts.

(3) The life insurance company taxable income of Target for the short taxable year ending in Year 2 ("short period") is the sum of the items determined in (a) below adjusted as provided in (b) below multiplied by the fraction in (c) below:

(a) Target's items of income or deduction (without regard to § 809(a)) for the short period is multiplied by a fraction, the numerator of which is the number of days in Year 2 and the denominator of which is the number of days in the short period;

(b) pursuant to § 809(a) Target's deduction for policyholder dividends under (a) above is reduced by Target's differential earnings amount, calculated with reference to Target's equity base as of the close of Year 1, Target's equity base as of the close of the short period, and the differential earnings rate for Year 2; and

(c) a fraction, the numerator of which is the number of days in the short period and the denominator of which is the number of days in Year 2.

(4) Pursuant to § 809(a), Acquiring's deduction for policyholder dividends in Year 2 is reduced by Acquiring's differential earnings amount for Year 2. For purposes of computing Acquiring's differential earnings amount for Year 2, a pro forma average equity base for Acquiring and Target combined will be computed as if Target had merged into Acquiring on December 31 of Year 1. Acquiring's equity base as of the close of Year 1 includes Target's equity base as of the close of Year 1. Acquiring's equity base as of the close of Year 2 includes Target's equity base. The pro forma differential earnings amount for Acquiring and Target combined will be computed by multiplying the pro forma average equity base for Acquiring and Target combined by the differential earnings rate for Year 2. The differential earnings amount for Acquiring will equal the pro forma differential earnings amount for Acquiring and Target combined minus an amount equal to the differential earnings amount for Target computed in accordance with ruling (3)(b) above multiplied by a fraction, the numerator of which is the number of days in the short period and the denominator of which is the number of days in Year 2.

(5) Pursuant to §§ 381(c)(22) and 809(f)(1) and (2), Acquiring shall take into account on its federal income tax return for the taxable year ending on December 31 of Year 3, the excess of the recomputed differential earnings amount for Target's short period over the differential earnings amount for Target's short period, or the excess of the differential earnings amount for Target's short period over the recomputed differential earnings amount for Target's short period as the case may be. For purposes of this ruling (5):

(a) the differential earnings amount for Target's short period shall equal the amount determined in ruling (3)(b) above multiplied by the fraction determined in ruling (3)(c) above, and

(b) the recomputed differential earnings amount for Target's short period shall be determined in the same manner as in ruling (5)(a) except that the recomputed differential earnings rate (as defined in § 1.809-9(b)(2)) for Year 2 shall be substituted for the differential earnings rate for Year 2.

(6) With respect to Target's Year 1 taxable year, to the extent that the recomputed differential earnings amount for Year 1 computed using the tentative recomputed differential earnings rate for Year 1 exceeds the differential earnings amount for that same year, Target will include such excess in life insurance gross income on its short period return. Similarly, with respect to Target's Year 1 taxable year, to the extent that the differential earnings amount for Year 1 exceeds the recomputed differential earnings amount for Year 1 computed using the tentative recomputed differential earnings rate for Year 1, such excess will be allowed as

a life insurance deduction for Target on its short period return.

(7) Acquiring will not include in net premiums under § 848(d)(1) any amount with respect to Target's assets transferred to Acquiring in consideration of the assumption by Acquiring of liabilities under Target's "specified insurance contracts" (within the meaning of § 848(e)). Further, Target will not be entitled to reduce its net premiums under § 848(d)(1) for the transfer of assets to Acquiring in consideration of the assumption by Acquiring of liabilities under Target's "specified insurance contracts" (within the meaning of § 848(e)). Pursuant to §§ 381(c)(4) and 381(c)(22), Acquiring will succeed to any capitalized balances of "specified policy acquisition expenses" (within the meaning of § 848(c)(1)) as determined by Target under § 848(c)(1) on the date of transfer, and such balances will continue to be amortized by Acquiring under Target's amortization schedule.

(8) Provided that § 381(c)(22) applies to the Merger and that the terms and conditions of the life insurance, annuity and other insurance contracts remain the same, the assumption by Acquiring, pursuant to the Merger, of liabilities under the contracts issued by Target have no effect on the date each contract was issued, entered into, purchased, or came into existence for all purposes of §§ 72(e)(4), 72(e)(5), 72(e)(10), 72(e)(11), 72(q), 72(s), 72(u), 72(v), 101(f), 264(a)(3), 264(a)(4), 7702 and 7702A. Moreover, Acquiring's assumption will not require retesting or the starting of new test periods under §§ 264(d)(1), 7702(f)(7)(B)-(E), and 7702A(c)(3)(A), and, for purposes of §§ 72(b) and (c)(4), Acquiring's assumption of annuity contracts with annuity starting dates before the Merger will not cause those contracts to be treated as having annuity starting dates after the Merger.

(9) The Acquiring proprietary interests received by Target policyholders in the Merger are continuing equity interests for purposes of determining whether the continuity of interest requirement under § 1.368-1(b) is satisfied.

(10) The Subsequent Transactions will not affect the qualification of the Merger as a reorganization under § 368(a)(1)(A).

(11) Provided the terms and conditions of the contracts remain the same after the Merger, the assumption by Acquiring, pursuant to the Merger, of liabilities under life insurance, annuity and other insurance contracts issued by Target will not cause such contracts to be treated as newly issued or otherwise cause a change in their treatment for purposes of all provisions of the Code applicable to plans qualified under §§ 401(a), 403(a), 403(b), and 408, regardless of the type of evidence of substitution of insurance companies received by each Target policyholder.

No opinion is expressed as to whether (1) the Merger constitutes a

§ 368(a)(1)(A) corporate reorganization, (2) the merger of Sub with and into NewSub as part of the Prior Transactions constitutes a § 368(a)(1)(F) reorganization, and (3) either § 368(a)(2)(C) or § 351 applies to any part of the Subsequent Transactions. In addition, no opinion is expressed about the tax treatment of the transactions under other provisions of the Code and the regulations or about 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.

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

It is important that a copy of this letter be attached to the federal income tax returns of the taxpayers involved for the taxable year in which the transaction covered by this letter is consummated.

Pursuant to the power of attorney on file in this office, a copy of this letter has been sent to your authorized representative.

Sincerely yours,
Associate Chief Counsel (Corporate)
By: Michael J. Wilder
Assistant Branch Chief, Branch 3